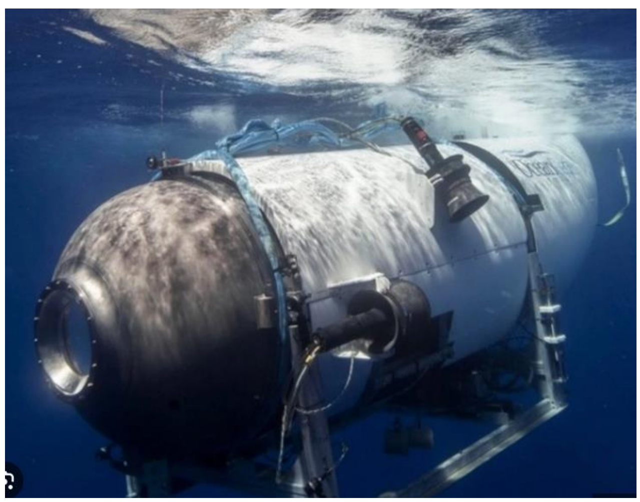
The Loser's Game

"Get you motor runnin'
Head out on the highway
Looking for adventure
In whatever comes our way"
-Born to Be Wild by Steppenwolf
https://www.youtube.com/watch?v=rMbATaj7Il8



Recently, while watching the tragic news of the OceanGate's Titanic tourist submersible, I started thinking about extreme tourism, and when does the thrill of exploration go from being a winner's game to a loser's game? Let's back up a minute and define a **"Loser's Game"**.

Way back in the 1980's, as a young aspiring investment professional, I came across a paper written by Charles Ellis in 1975 for the Financial Analysts Journal, titled "The Loser's Game". In this rather short but enlightening paper, Ellis explains how over the decades, professional investment management had evolved from a winner's game to a loser's game. In the early years of professional investment management, the professionals were in the minority and because of their education and work had a competitive advantage over the individual investors. But as more and more professionals entered the profession, they started competing more with each other instead of with the shrinking number of individuals. It became harder and harder to outperform the averages since the averages were made up of professionals. Markets became much more efficient. Investing became a loser's game.

The best example Ellis used to explain a loser's game was tennis. He used a study done by Dr. Ramo that broke tennis players into two groups; 1% who are elite, and 99% who are not elite. For the 1% who are elite, tennis is a winner's game. They focus their talent on serving aces, and hitting impossible to get to drop shots and passing shots.

For the other 99% of players, tennis is a loser's game. Dr. Ramo found that in amateur tennis 80% of the points were lost, not won. The victor in those matches is not the one who hits the most winners, but the one who makes the fewest mistakes. Rarely does the amateur see impressive rallies and miraculous shots, points are generally won when the opponent hits the ball into the net or out of bounds. The key to being a good tennis player is to focus on making fewer unforced errors than your opponent, while waiting for them to lose. You can win the loser's game by controlling mistakes.

Ellis goes on to talk about other loser's games, from war, to golf, to casino gambling, but the one that caught my imagination regarding the doomed Titan sub was the pilot. Ellis explained how during the early days of flight, being a pilot was a winner's game. It was an adventure and an adrenaline rush. But as time progressed, the game changed to one of making zero mistakes. Today you don't want to see your pilot come aboard the jet wearing a leather jacket, googles and a scarf. No, flying is now a total loser's game, the winner is the pilot who makes zero mistakes.

Undersea exploration is another of those endeavors that was initially a winner's game, where those who make discoveries and do something that has never been done before are idolized as heroes. We admire their bravery, their fortitude, and their determination. Sometimes that admiration turns to emulation, as we too seek to do something special. Of course, capitalism is designed to recognize a need and satisfy it; and therefore, enterprising entrepreneurs arise to make the average Joe into an extreme explorer. That's the moment exploration turns from a winner's game to a loser's game. And that is exactly what happened on the Titan, the margin for error was zero, as any mistakes would be catastrophic.

The crowds on Everest this year (Photo: Project Possible/Facebook)

Climbing Mount Everest is another of those endeavors that has evolved from a winner's game to a loser's game. We idolized Sir Edmund Hillary and his sherpa Tenzing Norgay who first climbed the summit in May 1953. In the 70 years since that first summit, approximately 6,100 people have successfully summitted. Today climbing Everest is a business, it costs about $55,000 to attempt the climb. This year a record 478 climbing permits were issued, 600 people summitted, with 350 of those being sherpas and 250 clients. So, about 52% of those permitted were successful, but there were also a record 17 deaths.

I like smoke and lightnin'
Heavy metal thunder
Racing with the wind
And the feeling that I'm under

Humans have always had that exploration gene, we love to seek the unknown, to discover and explore new frontiers. But there is a point where that new feeling is replaced with routine. That point where the game changes from rewarding winners to rewarding those that don't lose. Think of your average daily commute (assuming you still do that), there may have been a time when it was exciting but now the main goal is to get there without any incidents. The winner is he who arrives unscathed. Driving is a loser's game.

Investing may be the most competitive endeavor created. For every buyer there is a seller, and each is sure that the other is wrong. Multiply that by thousands of investors, and add in thousands of computer programs and now artificial intelligence, and you quickly realize that any perceived competitive advantage you thought you had is probably a figment of your imagination.

Investing is the ultimate loser's game, that doesn't mean you shouldn't play, it just means that you should modify your behavior to winning a loser's game, i.e., making fewer mistakes. Professional investors have many advantages over individuals, namely technology and access to information, but they also have a glaring weakness…time. Most professionals are ranked and rated monthly, quarterly, and yearly. Even if their long-term philosophy is sound, if their short-term performance is weak, they risk becoming unemployed. This focus on the short-term means that they are likely to attempt to hit more winners than just survive.

The biggest advantage that individual investors have over professionals is the luxury of time. As Charlie Munger once said, *"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."* In other words, Berkshire Hathaway focuses on making fewer mistakes over the long run.

My strategy over the years really hasn't changed that much, it has evolved some as I've learned more about myself, but this is my basic strategy which we employ at Medallion:

1. Limit the number of bets that you make versus the market, thereby limiting the number of mistakes you make.

    a. The market (i.e., S&P 500) is fully invested, therefore limit the amount of cash in your equity portfolio.
    b. The market is sector agnostic, those sectors with the highest market cap stocks get the biggest weights. In other words, those sectors with the most growth get the biggest weights. Therefore, have broad diversified sector exposure that nearly matches the markets sector weights.
2. Focus your energy on picking companies to own for the long-term.
    a. This is about making fewer mistakes, therefore concentrate your holdings to a few companies. In our case we only own about 35 stocks.
    b. Focus on companies that have a proven business model, a sustainable competitive advantage, and growth prospects.
    c. Focus on companies that have a history of rewarding shareholders through dividends or share repurchases. Companies that have a sound capital allocation strategy.
3. Valuation is not as important as owning great companies. As Warren Buffett says, *"I'd rather own a great company at a fair price than a mediocre company at a great price."* Once we own a great company, we love to add to them when investors are fearful, and sell some when markets get euphoric.
4. We sell a company when we have a better alternative.

The goal here is to win the loser's game by making fewer mistakes that our competitors over time. We try and concentrate our efforts by keeping things simple and taking a long-term view, allowing the wonders of compounding to work their magic on our portfolios.

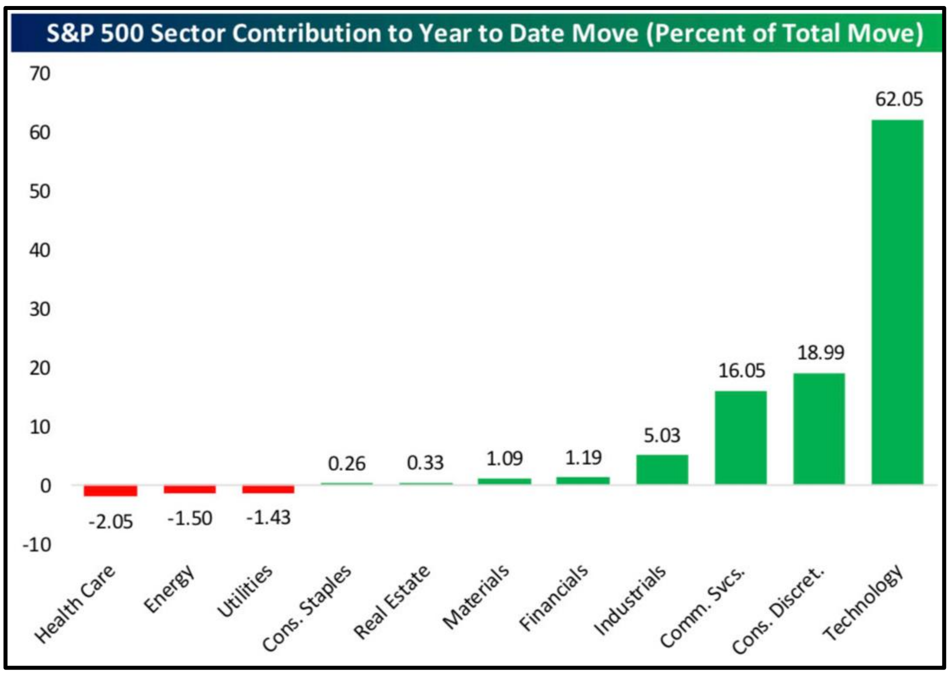
Market Commentary:

Yeah, darlin' gonna make it happen
Take the world in a love embrace
Fire all of your guns at once
And explode into space

Risk assets were certainly exploding into space in the first half of 2023! The Tech heavy NASDAQ 100 had its best start to any year since 1983, even better than the internet bubble years of 1998 and 1999, up a whopping 39.1%. The chart below highlights how the first half of 2023 was the opposite of 2022, with those assets doing the worst in 2022 rebounding the most in 2023.

CREATIVE PLANNING		Asset Class Total Returns Since 2011 (as of 6/30/23 - Data via YCharts)													@CharlieBilello	
ETF	Asset Class	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 YTD	2011-23 Cumulative	2011-23 Annualized
N/A	Bitcoin	1473%	186%	5507%	-58%	35%	125%	1331%	-73%	95%	301%	66%	-65%	**82.3%**	10044195%	151.3%
QQQ	US Nasdaq 100	3.4%	18.1%	36.6%	19.2%	9.5%	7.1%	32.7%	-0.1%	39.0%	48.6%	27.4%	-32.6%	**39.1%**	662.4%	17.6%
SPY	US Large Caps	1.9%	16.0%	32.2%	13.5%	1.2%	12.0%	21.7%	-4.5%	31.2%	18.4%	28.7%	-18.2%	**16.8%**	346.4%	12.7%
EFA	EAFE Stocks	-12.2%	18.8%	21.4%	-6.2%	-1.0%	1.4%	25.1%	-13.8%	22.0%	7.6%	11.5%	-14.4%	**12.5%**	81.1%	4.9%
CWB	Convertible Bonds	-7.7%	15.9%	20.5%	7.7%	-0.8%	10.6%	15.7%	-2.0%	22.4%	53.4%	2.2%	-19.4%	**9.6%**	192.5%	9.0%
IWM	US Small Caps	-4.4%	16.7%	38.7%	5.0%	-4.5%	21.6%	14.6%	-11.1%	25.4%	20.0%	14.5%	-20.5%	**8.1%**	184.8%	8.7%
EEM	EM Stocks	-18.8%	19.1%	-3.7%	-3.9%	-16.2%	10.9%	37.3%	-15.3%	18.2%	17.0%	-3.6%	-20.6%	**5.2%**	7.8%	0.6%
GLD	Gold	9.6%	6.6%	-28.3%	-2.2%	-10.7%	8.0%	12.8%	-1.9%	17.9%	24.8%	-4.2%	-0.8%	**5.1%**	28.5%	2.0%
TLT	Long Duration Treasuries	34.0%	2.6%	-13.4%	27.3%	-1.8%	1.2%	9.2%	-1.6%	14.1%	18.2%	-4.6%	-31.2%	**4.7%**	49.9%	3.3%
HYG	High Yield Bonds	6.8%	11.7%	5.8%	1.9%	-5.0%	13.4%	6.1%	-2.0%	14.1%	4.5%	3.8%	-11.0%	**4.5%**	65.4%	4.1%
EMB	EM Bonds (USD)	7.7%	16.9%	-7.8%	6.1%	1.0%	9.3%	10.3%	-5.5%	15.5%	5.4%	-2.2%	-18.6%	**4.4%**	43.2%	2.9%
LQD	Investment Grade Bonds	9.7%	10.6%	-2.0%	8.2%	-1.3%	6.2%	7.1%	-3.8%	17.4%	11.0%	-1.8%	-17.9%	**4.3%**	52.0%	3.4%
PFF	Preferred Stocks	-2.0%	17.8%	-1.0%	14.1%	4.3%	1.3%	8.1%	-4.7%	15.9%	7.9%	7.2%	-18.2%	**4.2%**	62.1%	3.9%
VNQ	US REITs	8.6%	17.6%	2.3%	30.4%	2.4%	8.6%	4.9%	-6.0%	28.9%	-4.7%	40.5%	-26.2%	**3.4%**	146.2%	7.5%
BND	US Total Bond Market	7.7%	3.9%	-2.1%	5.8%	0.6%	2.5%	3.6%	-0.1%	8.8%	7.7%	-1.9%	-13.1%	**2.4%**	26.5%	1.9%
BIL	US Cash	0.0%	0.0%	-0.1%	-0.1%	-0.1%	0.1%	0.7%	1.7%	2.2%	0.4%	-0.1%	1.4%	**2.2%**	8.6%	0.7%
TIP	TIPS	13.3%	6.4%	-8.5%	3.6%	-1.8%	4.7%	2.9%	-1.4%	8.3%	10.8%	5.7%	-12.2%	**2.0%**	35.5%	2.5%
DBC	Commodities	-2.6%	3.5%	-7.6%	-28.1%	-27.6%	18.6%	4.9%	-11.6%	11.8%	-7.8%	41.4%	19.3%	**-7.9%**	-14.7%	-1.3%
	Highest Return	BTC	BTC	BTC	VNQ	BTC	BTC	BTC	BIL	BTC	BTC	BTC	DBC	BTC	BTC	BTC
	Lowest Return	EEM	BIL	GLD	BTC	DBC	BIL	BIL	BTC	BIL	DBC	TLT	BTC	DBC	DBC	DBC
	% of Asset Classes Positive	61%	94%	44%	67%	39%	100%	100%	6%	100%	89%	61%	11%	94%	94%	94%

As far as sectors go, the Artificial Intelligence mega-cap Tech stocks were the overwhelming winners.

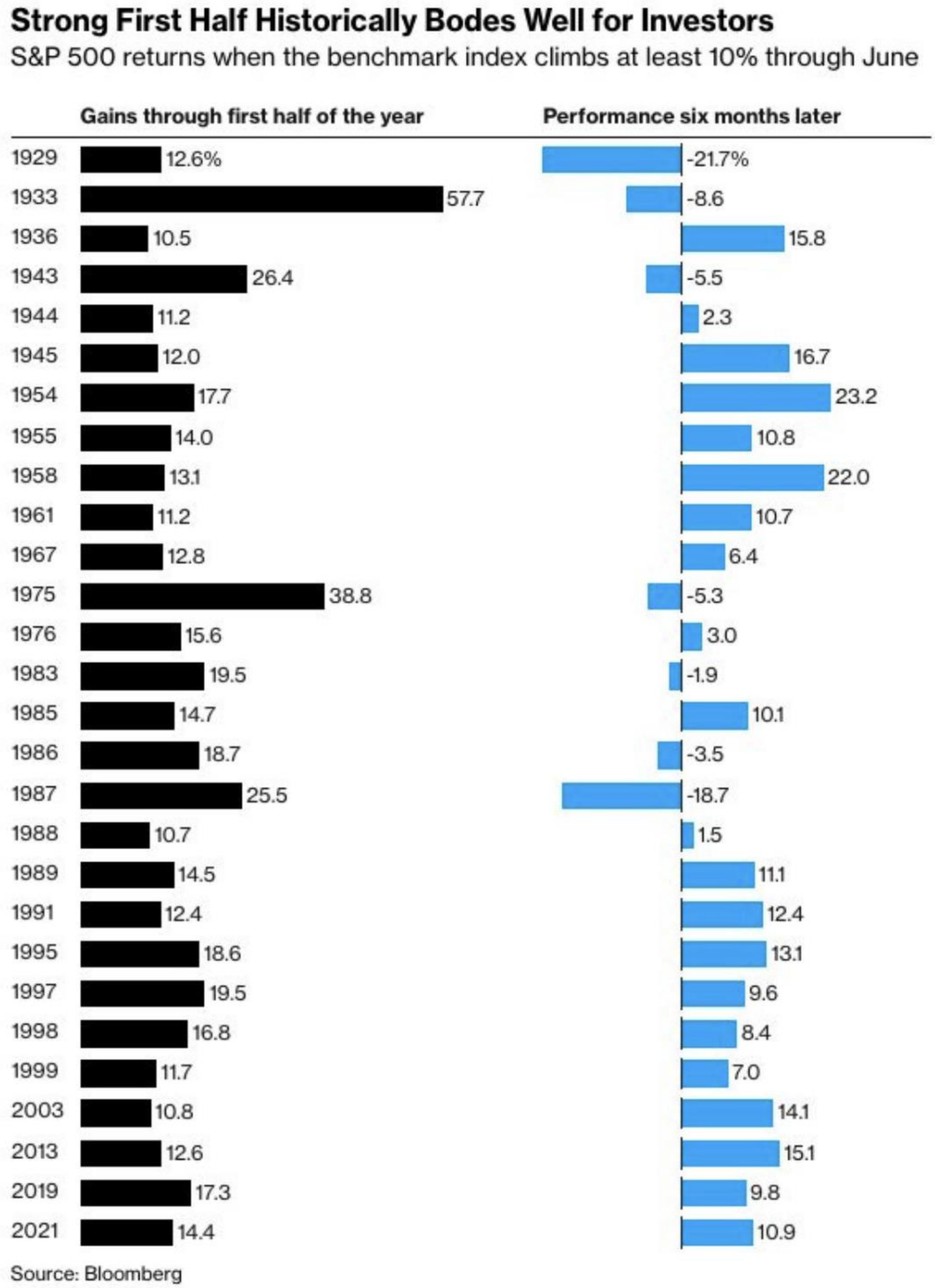


Dividend paying stocks had their largest relative underperformance verses non-dividend paying stocks since 2009. Again, risk-on was the clear winner of the first half.

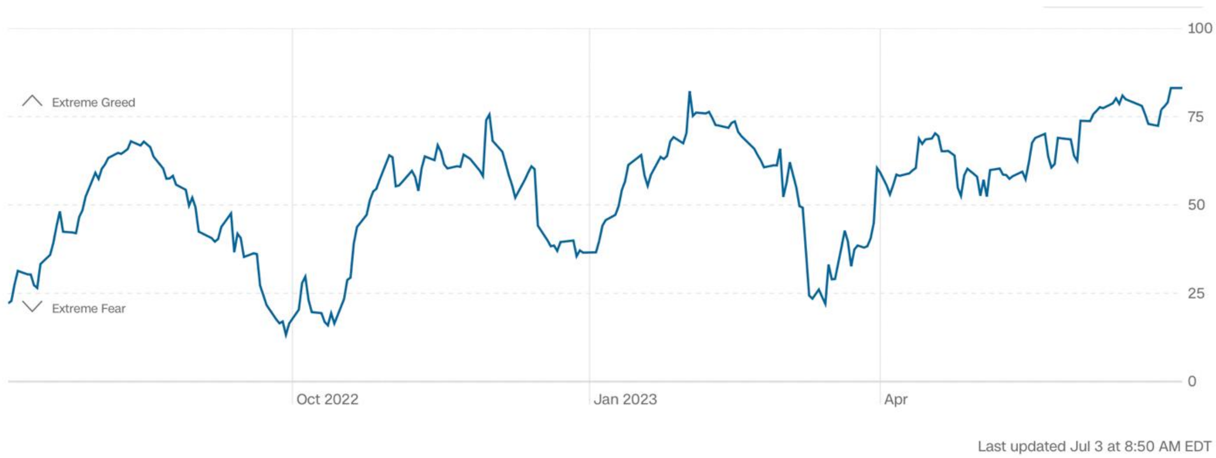
Bonds and Cash also had positive returns as the Fed continues hiking interest rates to combat inflation. And it appears to be working, as inflation rolls over and commodities decline in price.

What does this mean for the second half of 2023? Again, no one knows, but as history shows the momentum of a strong first half often continues into the second half. Not always, but often.

Since the early 1950's, whenever the index climbed more than 10% through June, it rises by a median of 10% in the second half.



If you believe, as Warren Buffett does, that you should be greedy when the crowd is fearful and fearful when the crowd is greedy, then you should pay attention to the CNN Fear & Greed Index. A year ago, the Fear/Greed index was at a reading of 24, extreme fear. At the beginning of this year the Fear/Greed index was at a fearful reading of 37. Both of those times were ideal times to buy stocks. Today, the reading is at extreme greed, 83. The crowd is greedy.



So, we have history telling us that usually a strong first half leads to a decent second half, but we have the Fear/Greed index telling us that we should be fearful. Who knows. My guesstimation is that the second half will see more muted gains. Again, remember that the riskiest assets led the markets higher (narrow leadership), and we still have a Fed that wants to hike rates to beat inflation back.

Our focus will be on winning the loser's game, making fewer mistakes, and letting our time advantage work its wonders.

Like a true nature's child
We were born
Born to be wild
We can climb so high
I never wanna die

As always, be careful out there.

Chris Wiles, CFA

Where trust is Earned