What Dilbert Can Teach Us About Investing

Have you ever played blackjack? If you haven't, here's a quick primer: the goal is to draw cards from the dealer, trying to make the cumulative value of your hand as close to 21 as possible without going higher. Scoring 21 is the ideal. A score of 20 is great, too, and 19 is almost as good. But anything 22 or higher is terrible—you automatically lose.

So imagine you are playing blackjack and you currently hold 17 points in your hand. The dealer asks if you want another card. Should you take it?

Well, there are four card denominations that could help you: aces, twos, threes, and fours. And there are thirteen total denominations in a deck, from ace through king.

Assuming the dealer is drawing from many decks all shuffled together, the chances of drawing one of the cards which could help are therefore about 4 in 13, or 31%. In other words, if you take another card while holding 17 points already, there is a 69% chance that you will go over 21 and automatically lose.

You're not going to take that card, are you?

Which is a good idea, and it's what we would do too.

Dumb Luck vs. Deserved Success

We recently read about someone who witnessed this exact situation, but the player actually decided to take another card. The dealer was surprised by the unconventional move and asked the player if he was sure. The player nodded, the dealer gave him another card, and—sure enough—it was a four. He scored 21 on the nose.

Here is how the author (baseball executive Paul DePodesta, of *Moneyball* fame) described the scene:

> "The place went crazy, high fives all around, everybody hootin' and hollerin', and you know what the dealer said? The dealer looked at the player, and with total sincerity, said: "Nice hit." I thought, "Nice hit? Maybe it was a nice hit for the casino, but it was a terrible hit for the player! The decision isn't justified just because it worked."

And that is exactly the right lesson: decisions aren't justified just because they work. Consider this simple two-by-two matrix from the book *Winning Decisions: Getting It Right the First Time* by J. Edward Russo and Paul J.H. Schoemaker:

	Good Outcome	Bad Outcome
Good Process	Deserved Success	Bad Break
Bad Process	Dumb Luck	Poetic Justice

We would argue that drawing a four while holding 17 would fall squarely in the bottom left quadrant of the chart: Dumb Luck.

Based on the chart, does having a good system or process in place mean that a good outcome will always be achieved? Absolutely not. In anything that involves probabilities, there will always be times when things don't go in your favor, even if probabilistically it was the right thing to do. These types of events will land you in the top right of the matrix: Bad Breaks.

We try to incorporate this same thinking in our investment style. While we are always striving to achieve "Deserved Success" in the portfolios we manage, we understand that it is inevitable that we will sometimes encounter a "Bad Break." Nevertheless, over the long term, our chances of success are improved by depending on a good process instead of a good outcome.

How To Fail at Almost Everything

You may know Scott Adams as the creator of a hilarious comic strip about the travails of a hapless office drone named Dilbert. But Mr. Adams is not only a successful cartoonist, he is also a world-class author. His latest book is a highly entertaining and informative read: *How to Fail at Almost Everything and Still Win Big.* In it, he talks a lot about goals versus systems. He defines a goal as "a specific objective that you either achieve or don't sometime in the future." On the other hand, he defines a system as "something you do on a regular basis that increases your odds of happiness in the long run."

As Adams states,

> "If you do something every day, it's a system. If you're waiting to achieve it someday in the future, it's a goal. In the world of dieting, losing twenty pounds is a goal, but eating right is a system. In the exercise realm, running a marathon in under four hours is a goal, but exercising daily is a system."

The problem with focusing on outcomes, as the blackjack case above illustrates, is that there is nothing that one can learn from dumb luck, as it cannot be replicated in a predictable way. But if one has a system in place, it can be studied, analyzed, and improved upon.

Adams and DePodesta have observed that most successful people follow systems and not goals; they focus on the process and not on the outcome. They develop a system or a process that they consistently follow.

Investing the Dilbert Way

We strongly agree with Adams and DePodesta, and we feel that this is especially relevant in the realm of investing. Investors often approach investing with the mindset of achieving specific goals or outcomes, instead of focusing on the underlying systems and processes. Buying a stock because your next-door neighbor gave you a "hot tip"–he thinks it is going to go up 20 percent in the coming year—is a goal and not a system. It is thinking about the outcome instead of the process, and we think it is a way of going about things that will inevitably, and painfully, lead to an ending of Poetic Justice.

We aim to keep ourselves firmly on the top row of the matrix: we are willing to withstand the occasional Bad Break, knowing that if we follow the right path we should at least earn our share of Deserved Success. Here is the process that we follow to do just that:

1. Think of Stocks as Businesses

   Stocks are not just random ticker symbols going around at the bottom of the CNBC screen; they are actual companies providing products and services and generating profits for their owners (shareholders). View investing not as the arbitrary trading of slips of paper, but as the part-ownership of actual businesses.

2. Calculate Intrinsic Value

   For every company that you buy, or are thinking of buying, calculate the intrinsic value of that company. What is intrinsic value? The intrinsic value of any asset, be it a stock or a farm or the local McDonald's franchise, is the discounted value of the cash that can be produced during its remaining life.

3. Insist on a Margin of Safety

   Once you have an estimate of the intrinsic value of the business, and only then, you can make a decision on whether to buy the stock. Before buying, insist on a margin of safety. This means that a stock will only be bought when it is trading at a significant discount to intrinsic value.

4. Monitor Investments

   At the time of buying an investment, write down the reasons you bought it. As time goes by, look for disconfirming evidence that challenges your original thesis.

5. Know When to Sell

   Sell a stock when one of the following occurs:
   a. The stock reaches intrinsic value
   b. Other, more attractive opportunities are found
   c. There is a change in the competitive dynamic of the business or the industry
   d. A mistake was made in valuation or assessing the competitive advantages of the business

6. Review, Learn, Repeat

Conclusion

Many investors focus on outcomes instead of processes when making investing decisions. That focus will most likely hurt investing returns over the long term. Instead of looking for the next “hot tip,” increase your odds of superior returns by having a good investing process in place.

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