Mauboussin, Michael J. – The Success Equation

Harvard Business Review, 2012, [Finance] Grade ★★★★★

Michael Mauboussin is a strategist at Legg Mason and previously at CSFB. He is also a teacher at Columbia, a trustee board member of Santa Fe Institute and one of the two persons that have influenced my financial thinking the most. Mauboussins's new book aims to explain the elements of skill and luck in business, sports and investing. Most activities are a blend of skill and luck and hence the job becomes to place them on the luck-skill continuum. Investing is mainly dominated by luck.

With deeper understanding of luck vs. skill we can design rational operations, do better forecasts and develop skill in ways that fit the activity. "*The key to statistical prediction is to figure out how much weight you should assign to the base rate and specific case.*" When skill dominates, the specific case should be given higher weight. When luck dominates, the base rate (the probabilities according to evidence from prior similar situations) should be prioritized. The more random a process the stronger the reversal to the mean will be. This means that in areas of skill a few observations can sort out skill from lack of skill. In more random areas the skill that exists will only be observable after a large number of observations.

The greatest misunderstandings occur in the areas where randomness dominates. Humans create stories of cause-and-effect to make sense of the world and hence see developments as more non-random then they really are. One fallacy due to an inability to understand reversal to the mean, in this book called "the dumb money effect" is when capital is allocated to assets, investment managers, investment styles etc. because of recent outperformance the last few years. An effect estimated to have cost investors one yearly percentage point of returns historically.

Mauboussin brings forward useful methods on how to specify and estimate the rate of reversal to the mean and also dissects the most common mean reversion mistakes. One of these, "the

illusion of declining variance", is a mistake you see all too often - for example, as the author points out, when it comes to the reversal to the mean in companies' return on invested capital. This reversal does not mean that all companies in the future will earn the same returns.

In areas where skill dominates, say basketball, the way to improve is through so called deliberate practice. In more mixed areas checklists is a good tool to improve performance. In more random areas the way to improve is to focus on process.

Even though the author shows that which song (or book) that becomes a smash hit, due to complex social interactions and feedback loops, is close to random, *The Success Equation* could very well become a best seller. Mauboussin combines the deep knowledge, logical ability, pleasant language and pedagogical skills from previous books with a broadening of scope. This is a book on popular science more than on investments. The origin to the book is four or five reports that made their way to Mauboussin's two excellent previous books. He has now expanded on these topics mainly by adding material and examples from the world of sports. The topics are vital for investing and a must to understand, but for those who have read the author's previous texts there is not much new material directly linked to investments.

The topic that occupied my mind after finishing the book was whether I agreed with Mauboussin or not on his definition of investing skill and expertise; "*Deliberate practice and the concept of expertise apply only to the skill side of the luck-skill continuum.*" It's true that you can't make ten thousand investments just like you practice free throws and by time automatize skill by adding myelin onto neural path ways. However, couldn't expanding your knowledge and understanding of the best processes also be seen as a type of deliberate practice on a higher level? Over time you will internalize what is likely to work and what is not.

Mats Larsson, December 22, 2012