Make the chances work for you

Roger Montgomery highlights the importance of probability in investment decisions

SUCCESSFUL EQUITY INVESTING can be done in many different ways and by people with very different combinations of skills. However, there are a few skills that should form part of the toolkit for any sharemarket investor. One of the more underrated skills is a sound understanding of the role that probability and chance play in determining investment success.

As professional investors, we like to think that our ability to spot value will ensure that we achieve good returns for our clients over time and, in the long run, this is likely to be the case. However, in the short run the story is more complicated. A good way to illustrate this is to think about how many investment decisions a good investor can expect to get right out of 100. This is a question that researchers have sought to answer and we have done some analysis on our own investment approach to understand what constitutes "good" performance.

The answer may surprise you: an investor who can achieve 55 good calls out of 100, or 5% more than you might expect to get by flipping a coin, deserves a pat on the back. This may seem a small margin of improvement over choosing investments at random, and it is. It simply reflects that the future is not easy to predict, the equity market is full of bright people searching for the best opportunities and it's difficult to beat them to it. If an investment is obviously a good one, smart people will bid up the share price until it is no longer cheap.

Knowing that the margin of success is thin can help you to understand how to assess investment stories. For example, if someone recommends a stock to you and that stock goes well (or poorly), it doesn't necessarily mean that the recommendation was particularly skilful (or otherwise). For individual decisions, luck plays too big a role and it's only by looking at a large number of separate decisions over an extended period that the investment skill starts to cut through the haze of random chance. This is why funds managers are typically judged on multi-year track records that incorporate hundreds of investment decisions.

The next time you are minded to follow the advice of an investment professional, a tip sheet or even an "expert", consider whether you have enough evidence to feel confident in their abilities. Anecdotes and examples can be interesting but are seldom adequate evidence.

Another useful insight from understanding probabilities is the way you should think about risk. Many investors take the view it is bad, something that needs to be minimised. The reality is more subtle.

Imagine you have the opportunity to accept a bet where you have a 60% chance of doubling your money and a 40% chance of losing everything. Is this a reasonable bet to take, or is it irresponsible gambling?

The reality is that this bet is probably better than most of the investment opportunities you are likely to see. Recall that a good investor may get 55% of their calls right in the equity market.

Clearly, it would be unwise to put everything you have into this bet but imagine if you had the ability to put a small amount of money into such a bet every week. Some weeks you would lose, but most weeks you would win. Provided you risk a limited amount of capital each time, you are guaranteed to do well over the long term. The same logic applies to investments that have an equal chance of success or failure, but the gains from success are much greater than the losses in the event of failure.

GETTY IMAGES

A recent example of probability and risk in action was Montgomery's purchase of McMillan Shakespeare shares at $7 after Kevin Rudd proposed changes to fringe benefits tax. The shares of the salary packaging company fell more than 50% but an assessment of the Labor's chance of victory at the elections meant the probability of the proposed legislation seeing the light of day was slim. The shares were trading near $13 just a few weeks later.

You won't find such opportunities every week, but if you have a diversified investment portfolio and you continue investing for many years, then it makes good sense to allocate a limited amount of capital to this type of opportunity. The thing to remember is that risk – if it is adequately rewarded and properly managed – is a good thing. It is something you should seek out rather than avoid. That small-cap company that could go to the wall but has a fairly good chance of achieving great things might just make good sense if it is part of a broader portfolio.

Of course, you still need to do your homework – the small-cap company that is likely to go to the wall and has only a faint chance of making it big is still a dreadful investment. This, by the way, describes a large percentage of the smaller explorers and junior miners listed on the ASX.

Investors must understand "probabilities" to be successful and, because so many don't, the probability of being successful is that much greater for those who do.

Roger Montgomery is a portfolio manager at Montgomery Investment Management. For his book, Value.Able, *see www.rogermontgomery.com.*