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Behavioral Issues in Investing

I have told several investors Blue Grotto Capital attempts to achieve a behavioral advantage. This letter discusses some of the behavioral issues I have thought through while mapping out my investing process. Behavioral psychology has a complex interaction with an investor's process and this letter lays out how we have set up our process to guard against behavioral pitfalls and specifically my personal tendencies. While we won't go through the multitude of cognitive biases that exist, we hope reciprocation tendency results from this letter (for those who want to study the different cognitive biases in more detail, we suggest reading or listening to Charlie Munger's *The Psychology of Human Misjudgment*, available online).

Michael Mauboussin, Chief Strategist at Credit Suisse said the following: "*We have no control over outcomes, but we can control the process. Of course, outcomes matter, but by focusing our attention on process we maximize our chances of good outcomes."* No one can accurately predict the future with any certainty, because there are far too many variables to predict. You can be completely right, for instance, that a company has a good business position, good management, low valuation, and therefore excellent prospects. But then an irrational competitor comes into the market out of the blue and changes everything. Or you could be short a bad company with shrinking sales and earnings at an outrageous valuation and bad management, but then a Japanese company, for some reason, comes in and buys it out at a big premium.

A good process lines up probabilities when they are highly in your favor and systematically attempts to maximize these bets *to the extent the bet size does not adversely influence one's psychology*. To quote a famous old-time poker player, Puggy Pearson, "Ain't only three things to gambling: knowing the 60-40 end of the proposition, money management, and knowing yourself. Any donkey knows that." By diversifying into a collection of bets that are probabilistically in your favor, you can deal with an unknowable future. Developing a money management process that is consistent with your personality improves the odds of systematic execution.

A good process both identifies when things are going wrong and deals with it through money management principals and diversification. It also identifies when things are going right and makes sure the bet size is big enough. George Soros is famous for the philosophy of "when you're right, you can never have too big of a bet." But to make big bets like this he also had a process for exiting when he was wrong and not tying his ego to whatever bet he was making. Plus, he famously benefitted from getting back aches when he was in a position that he shouldn't have been in, which was beneficial for his timing.

One of the pioneers of quantitative investment, famous for being one of the first card counters in blackjack and author of *Beat the Dealer,* Ed Thorpe, utilized a formula for sizing his bets called the Kelly Criterion. The Kelly formula was used to determine the optimal size of a series of bets. It was first laid out by J. L. Kelly, Jr, a researcher at Bell Labs, in 1956.

Some investors embrace this formula as a way to determine bet sizes in portfolio investing. I won't get into the math here, but generally if you have good odds of winning, the formula suggests taking a relatively large sized bet. The Kelly formula is an intellectually interesting way to determine sizing, as it mathematically and intuitively makes sense. Most people who use it reduce the size of their bets to "half Kelly," which takes into account the impracticalities of how concentrated the formula suggests you should be. Humans naturally "feel" losses are 2x worse than gains "feel" good, so running "full Kelly" has a psychological consequence most can't deal with. I think the formula works well for bets where you know the probabilities. If you are a blackjack player counting cards, or Mr. Thorpe making arbitrage bets as he did in his hedge fund, the theory is a great way to think about sizing.

However, the formula assumes you know the probabilities of success, and if you are making bets on a long or a short, the probabilities are highly uncertain. This is why I favor Bayesian Updating, which offers a more practical way of consistently updating probabilities based on the constant information flow you are receiving following a business. While markets are generally efficient, sometimes they are slow to incorporate new information (Bayesian Updating is discussed more below), especially when the new information is incorporated into an accumulation of data points that help bolster a more complex mosaic.

The Kelly Criterion is just using math where common sense would do, in that you should always be trying to line up asymmetric investments where if you win you win big and if you lose the amount you lose is relatively small. The main problem though is that in the real world it is tough to assign a number to the probability. I can imagine a reader thinking, but what if you do a ton of work to make sure you're right? In fact, if you've done more work, it may be a bad sign, something quite counterintuitive, which I'll explain later. Strong due diligence is important, but disproportionate amounts of work may lead to an interesting cognitive misjudgment.

I view position sizing, like many issues in investing, as a balancing act. Every position you take should be asymmetric in nature, with most positions lining up at least a few variables. For instance, you might get into a short because you think it's a fad, with a below average business position. However, if it's unclear whether the fad is going to fade right away, you might just take a smaller sized position and then scale the position up as timing data points suggest business momentum is deteriorating. Similarly, you might take a position in a long where the business position, management, and timing line up, but valuation is just ok (note it can't be unattractive). The rare position is one where everything lines up – business quality (which includes management strength and how strong of a moat and business model the company has), timing (business momentum), and valuation. While most value investors tend to overweight valuation when making sizing decisions, I find that timing is a more important variable, both psychologically and to maximize short-term returns when you are taking this stance. However, for Blue Grotto to take a supersized position, all three variables must line up perfectly. This only really happens a half a dozen times a year, if you are lucky.

The Inside and Outside View and Flexibility in Forecasting

Except for the fact that I believe in my product, I'm not a natural salesperson. Those of you I've met have probably noticed that I don't exude overconfidence, something that most people expect when meeting with cocky hedge fund managers. Part of this may be that I am somewhat introverted and tend to only directly answer questions as they are asked. I also come across more even-keeled, because I have learned through more than a decade of experience that you need to strike a balance between taking a hard stance on something (you must take risks to make money) and keeping your mind open to the possibility of being wrong. This is a humbling business. Overconfidence is a huge, but widely prevalent error, especially among ultra-competitive hedge fund managers. Edgy is overrated. Unemotional is a better trait when it comes to investing. I try to focus on being both creative and flexible.

Every hedge fund manager is effectively a forecaster. If you are an allocator to hedge funds, you are also making an explicit forecast that the hedge fund manager is going to be successful in generating returns and mitigating risk. Part of being a great forecaster is having the right focus. It's important to find situations where your work is likely to pay off.

This is where the categories (we'll talk about these categories in future pieces) where I've historically been successful in finding high returns come in – if there is a great capital allocator at the helm of a company or there is a supply driven cycle that suggests an industry will have substantial pricing power, you're more likely to find a great investment. If you're drilling for oil it's more likely you find it where there has been nearby discoveries or at least geological features that are like previous successful wells. My previous letter laid out how I triage potential investments by going through a virtual funnel, with various sources of initial research leading me to various opportunities. By focusing on factors, qualitative and quantitative, that have lead to success in the past, I am able to find situations where I can have better odds of making a probabilistic assessment of the situation that is correct.

Another way to become a strong forecaster is to take both an inside and outside view on potential investments. When I'm assessing a business, my analysts and I are drilling into the details on the business and getting a granular view on the management team, products, capabilities, and culture of the company. This represents what psychologists call the *inside view.* But as a generalist I'm also always thinking about the *outside view* on the business – what is the "base rate" probability this will work? This is determined by the valuation starting point, the underlying characteristics of the business (has it historically experienced good return levels), the sustainability of the balance sheet, etc.

The outside view, in a less general sense, can be used to evaluate business outcomes. In biotech, if you were looking at the base rate of success for a drug in a Phase 3 trial, the likelihood of success is around 58% (I have seen higher probability estimates based on more recent filings, but this number is over a longer time period). If you are analyzing a biotech company where a Phase 3 drug is a critical value driver, of course you want to have reasons why the drug is more likely to succeed. To have a substantially different forecast than 58%, you would need to take a fairly aggressive inside view. A more nuanced outside view here would be that companies have gotten better at guiding companies through the Phase 3 stage of trials, so the actual probability is now 65% or higher. Then perhaps an inside view based on prior data, analogous other drugs, and other factors could edge your probability estimate up to 75%. Good forecasters consider both the inside view (the realm of sector-specific focused analysts) and the outside view, which considers probabilities applied to bigger systems or potential outcomes.

In addition to assessing situations in multiple ways, it is also important to be extremely flexible in your thinking about each investment you make. Jonathan Baron, a professor at the University of Pennsylvania, runs tests for "active open-mindedness," an attribute I look for in analysts I hire. The test asks whether you agree with the following:

- *People should take into consideration evidence that goes against their beliefs.*
- *It is more useful to pay attention to those who disagree with you than to those who agree.*
- *Changing your mind is a sign of weakness.*
- *Intuition is the best guide in making decisions.*
- *It is important to persevere in your beliefs even when evidence is brought to bear against them.*

I doubt it will be a surprise to my readers that people who prove to be better forecasters tend to test their beliefs continually against evidence and seek out contradictory sources of information.

Whenever you are buying or selling a stock, someone is on the other side of the trade and in general the market is broadly quite smart. One thing Tom Claugus at GMT Capital taught me is to never assume the average market participant in a stock is unintelligent. However, great investors line up several factors in their favor and consider why other market participants might be doing something different than they are doing. For instance, a value investor might know that the short-term news on a company or industry is quite negative, which is why a stock is down or depressed, and hence take a longer-term stance on the industry mean reverting over time.

Many momentum investors believe buying stocks near their highs is a smart thing to do, because when a stock is near its high, no one is getting hurt. Everyone in the stock is making money and hence complacent, while people not in the stock may feel they are missing out. In many cases the intrinsic value of the stock is significantly lower, so value or fundamental investors may be selling to this momentum investor. The momentum investor could be right in the short-term in this case, but the question is does that momentum investor have good discipline when it comes to selling when momentum stalls. Eventually the momentum fails, and all that is left is an overvalued security. The momentum investor is relying on human behavior, suggesting that holders are more complacent when they don't have a loss in a position and investors on the sidelines feel like they are missing out.

If you are taking a short position in a growth stock that is overvalued, at the very least you should have a good view on what the person who is buying the stock you're selling is thinking. Or on the long side, value investors tend to ignore some "momentum factors" the real world creates. George Soros has addressed and defined a concept he calls reflexivity. There are many situations that result in boom/bust situations, the most obvious of which is a roll up of businesses that trades at a high multiple. Because it trades at a high multiple, it can afford to buy other businesses more cheaply, which creates more earnings growth and reinforces the high multiple a stock trades at prior to its acquisitions. This was, for instance, why conglomerates in the 1960s experienced boom/bust cycles. Indeed, part of Tesla's success during this cycle has been the ability of the company to continually finance its cash burn with fresh equity at high prices.

In my experience, growth investors make the mistake of ignoring value more often than value investors make the mistake of ignoring growth. I once sat on a panel with some fellow hedge fund managers where one of the managers argued that "value doesn't matter in tech." He then proceeded to cite Nokia, which had recently rallied significantly and then was purchased in part by Microsoft, as an example where "value didn't matter." In other words, he disproved his own point. (As an aside, I believe Microsoft's purchase of Nokia was an absurd mistake, but in this case, Microsoft thought Nokia offered value). More often, growth investors bid high growth stocks to absurd values and then end up disappointed when the company doesn't live up to unrealistic expectations. I think the current environment has many more cases of growth investors ignoring value than vice versa.

Stubborn vs. Flexible: A Balancing Act

Having watched many analysts/PMs manage money, I would make the observation that there is a continuum of personalities ranging from extremely stubborn to 100% flexible. I think both sides of this continuum can lead to ruin as an investor. Being overly stubborn as a short seller is very hazardous to your financial health. Even the best short sellers are wrong at least 30% of the time and letting those positions compound on you for too long can really hurt returns. That being said, I have historically erred on the side of being too flexible, which also can be a mistake. You can't be shaken out of any position on any setback because most stocks I've successfully owned or have shorted have had multiple moves against me during the duration of my holding period. Sometimes the market is just wrong, or you are just early. I think this is a difficult balancing act for a Portfolio Manager, but in my mind the key is to simply focus on whether your fundamental thesis is still in-tact. If the reasons why you got into the position are not holding true, that is a sign your thesis was incorrect and it's time to move on. Have the courage of your convictions, but don't be pigheaded or ignore contrary evidence.

The Makeup of a Great Analyst

Most professional investors have a high IQ; it is rare that I meet people who work for hedge funds or mutual funds that are not highly intelligent. Many of the people I've worked with in the past have been smarter than I am in terms of IQ and understanding of various subjects like engineering, technology, the health care system, or drilling technology. However, I've found that a lot of these smart people are not great investors, because they are not able to coordinate all the facts they acquire and assimilate them into what matters. Or conversely, they become too smart for their own good and fail to utilize common sense. Maybe there is something about growing up smarter than everyone else that inflates the person's self-esteem in a way that makes it difficult to admit they are wrong.

In any case, investing is not about IQ. You need to have a reasonable IQ, but once you are "smart enough," this is not the key determinant of whether you are successful as an investor. In his book *Outliers*, Malcolm Gladwell cites the examples of Chris Langan, a genius with a 195 IQ and Robert Oppenheimer, the eventual leader of the Manhattan Project. While Langan probably had a higher IQ than Oppenheimer, Langan couldn't negotiate the world effectively. Gladwell highlights an incident where Oppenheimer actually tried to kill one of his professors and negotiated his way out of the consequences of that. The point he was making is that while society tends to put more credence on IQ, the ability to negotiate the world through interpersonal interactions and other skill sets is more important in most fields.

I think common sense is probably more important in investing than almost anything. Charlie Munger cites the ability to not do anything stupid as a major factor in Berkshire's success. For instance, it's obvious that you should not substantially overpay for companies, buy good businesses when they are undervalued and unloved, and make certain the company you buy isn't over earning. However, many investors get in their own way. Personally, I have found that when I've made a big mistake investing (long), it has been because I invest in companies that lack durability. So now, I try to guard against investing in anything with style or fickle consumer preference as a major driver.

In my view, there are several major skill sets and personality traits you need to be a good investor:

Skills:

1) **Business analyst -** You must be a capable, or preferably, an excellent business analyst. If you don't have good business judgment, it's unlikely you will be a good investor. (I would note this is not true of non-fundamental investors, for instance technical analysts or people following a quant or non-judgment-based process, but I don't know how to reliably make money in these ways). I could write an entire book on business analysis, which is what I spend most of my time on and is the most important aspect of being a good investor. After all, investing is really all about trying to own the best businesses at the cheapest prices. As Benjamin Graham says (and Warren Buffett recently quoted), "Investment is most intelligent when it is most businesslike." If you don't have good business judgment, it is unlikely you will be a good investor.
2) **Data assimilator** - A good investor can assimilate data vis-a-vis a stock price and overall context of the current market, economy, sector, and business you are analyzing.
3) **Poker player** - A good investor shares many of the same traits as a good poker player. They know how to size up and down bets based on probabilities; make big bets when there is very little risk and high potential reward and cut bets significantly or entirely when risk/reward is unfavorable. The great thing about investing compared to poker, is there is no ante, you can play only when you have the nuts if you want. For those who don't play poker, what that means is you can just sit around and do nothing until or unless you find something incredibly compelling. The problem most people find is they don't have the patience to sit around and wait. Over-activity is the enemy of returns in investing.
4) **Multi-disciplinary perspective** – Charlie Munger talks about the importance of learning from all disciplines and using them all to assess issues with businesses and various other factors. For instance, there are key concepts or tenants of psychology, engineering, mathematics, science, sociology, finance, accounting, and history that provide important lessons that can help you as an investor. Munger's hero is Benjamin Franklin. George Soros says his hero is Karl Popper, who was not a great investor but the person who invented, or first clearly communicated, the scientific method. I can't think of two more qualified people to follow than these legendary investors.
5) **Ability to boil things down to what matters** – at GMT a big focus was figuring out and assessing the "key issues" – the two to four things that are going to determine whether an investment will be successful. For instance, in a commodity business, usually the key issue is the supply/demand for the commodity and the cost position of the producer.

Personality Traits:

1) **Emotional balance** – you must be rational and able to separate yourself from whatever prior judgments you have made, good or bad. I believe I am good at this, although everyone gets emotional and should tailor their process to try to avoid emotional decision-making whenever possible.
2) **Intellectual honesty** – As an investor, you have to be able to see the world as it is, not as you would like it to be. The best investors are right about 70% of the time. Minimizing bets on the 30%+ of the time you are wrong requires you to put your ego in check and admit when you were off base on an investment.
3) **Ability to learn from mistakes** – The successful investor must digest the lessons from mistakes and successes and internalize them. Jesse Livermore used to say that mistakes where he lost money were lessons where he paid tuition. Mr. Livermore was a great trader, partially because he learned and didn't consistently make the same mistakes over and over. This requires a successful feedback loop.
4) **Creativity** – While having a discipline and sticking with it is important, the reality is investing is part science and part art. Coming up with creative ideas that are unique or different is something I've always been good at. Most great investors I respect find off the beaten path stocks or different ways of looking at businesses or stocks.
5) **Accurate self-knowledge** – Some people will be much more comfortable being strict value investors, while others prefer to own high quality businesses at just reasonable prices. Other investors may be

more growth or momentum oriented. The key for any investor is to stick to what you are comfortable with, both from a style and process perspective. An investor also has to be wary of following others into investments. Always invest based on the facts you yourself assimilate and come to your own conclusion. Blindly following others' opinions is a classic fallacy that can lead many people to lose money even when the person you are following is right. If you don't have the courage of your own convictions, it's likely you will panic at the wrong time and not hold on when something bad or concerning happens.

All of these skills and traits are important in establishing an overall methodology, temperament, attitude, and framework for being a successful investor. Frankly, the psychological aspects of investing are some of the hardest to learn if you don't have a natural aptitude for them already. Being intellectually honest even when it means you were wrong in prior decisions is particularly hard for most people.

Risk Aversion Spectrum

Another key factor to consider about yourself is where you are on a spectrum of risk-seeking behavior. Having worked with a number of analysts and portfolio managers through the years, I have seen extremely risk averse people whose main motivation is not to be wrong. I have also seen those who want to constantly be doing something and who are strong risk seekers. Risk seekers tend to want to take a lot of bets and get involved in various situations. Risk averse people are more likely to wait around and only do something they think has a high probability of paying off.

I personally view myself as relatively balanced on this spectrum (although I have been told by others I am more risk seeking). I find that when I first do work on a position and it meets all my "outside view" criteria, I tend to get overly excited. Applying a brake on my behavior at this point and only taking a partial position over the short term is helpful, because it prevents me from making big mistakes when I first get involved. I think it is important to recognize generally where you are on the risk spectrum and set up some rules. If risk averse, perhaps you should force yourself to make bigger bets when you eventually decide to do something. If risk seeking, start with smaller position sizing and/or give yourself a cooling off period from your initial investment, something that is a big part of our process at Blue Grotto Capital.

My more nuanced view of myself is I am generally risk seeking when it comes to new positions, but I become more risk averse once I'm in a position. Sizing positions up once I've been in them a while is harder for me to do than take a smaller initial position. Consequently, I find it helpful to slow myself down, but then force myself to get to a 5% position on a long or a 2%+ position on a short in approximately six months, if data points suggest I am right. This is necessary to provide an impetus to getting bigger. Anytime I size a position up to 10%, which I am planning to do only when business timing is very strong relative to valuation, the risk/reward is likely to be very good given my personal psychology.

Contrarian or Consensus Tendency

Another psychological trait to consider is whether you tend to want to make contrarian bets or ride consensus calls. I find myself strongly on the side of wanting to be a contrarian more often than not. When I was growing up, my parents thought I'd be a lawyer, because I liked to argue with people so much. This tends to carry over into the markets, where I like to "argue with the market." As a result, one of the number one items on my "investing checklist" is to make sure I am anchoring on the most recent results a company has reported and not shorting improving businesses or going long deteriorating businesses. My tendency is to want to be contrarian, so it is important for me to balance this tendency with a process that improves my orientation towards not fighting business trends. As an aside, my wife loves how I like to argue.

When "I've Done a Ton of Work" is a Bad Sign

I have found it difficult for my entire career to make the best position I have the biggest position. In fact, more often than not, my biggest positions have not been even in the top half of my positions. Why is this the case?

I read that Capital Research Group, one of the largest mutual fund companies in the world with a good track record and a reputation for good analysts with sector focuses, had incubated several "analyst best idea" funds. Unfortunately, each one of those funds was eventually shut down due to underperformance. Charlie Munger reportedly asked someone there why that was? Their response was that most analysts contributed the stocks that they spent the most time on as their best ideas, while spending the most time on the idea was not actually correlated with it being the best. Munger called this commitment and consistency bias. When mentioning this to former colleagues and friends in the business, they mentioned similar experiences at top-ranked hedge funds where their "best ideas" did poorly. An allocator I mentioned this to said that one hedge fund manager they talk with always asks other managers, "What's your second-best idea?"

This resonated with me, as I have often found problem positions that weren't working out as planned have inevitably ended up being ones I spent the most time on. As a result, on many occasions I've increased the position sizing associated with them. Often initial underperformance of the idea caused valuation to move lower (or higher in the case of shorts), giving me more of a valuation case to anchor on as I dig in more and more to the fundamentals and retain the viewpoint.

As a result, I try to adjust my mental biases and follow trading aphorisms like "losers average losers," or Peter Lynch's "don't water the weeds and dig up the flowers." Still, I find that simply taking similar-sized positions for all of my initial positions may result in better performance, which indeed has been the case historically. While I realize theoretically that equally weighting positions is not optimal, I find position sizing to be a very blunt and clumsy tool.

I also rank my portfolio positions against each other periodically. While this can be useful, I find the worst positions are the ones that stand out the most, while good positions are generally hard to differentiate. If you are long five different positions that have top-notch management teams, business positions, and good business momentum, picking the best one of these five is difficult. However, if there is a sixth one where the management team has been bothering you or the business position isn't as good, this position stands out among the six positions. In this example, the sixth position would be a great candidate for cutting and making room for better positions. Ranking a portfolio helps guard against *endowment effect*, where people tend to view things they own as being more valuable than other items (in this case stocks) for sale.

Sizing and Bayesian Updating

While moving to a 5% position at cost on average on a long or a 2% position on average on a short is what I gravitate to, the way I size positions is much more nuanced. First, to get to a "fully-sized position," the data points you are following vis-a-vis the price (and hence implied valuation) have to be consistent with the original thesis or better for at least six months. Markets are dynamic, with a constant interaction occurring between valuations of businesses and data points that provide you information on the businesses. The more you are leveraging your feedback loop over time and updating the probabilities on your positions, the more sizing will differ. A number of positions won't get sized up fully, because: 1) price runs away from you before you can be fully comfortable that you have seen enough data to ensure you are right, or 2) the data points won't be consistent with the original thesis or are uninspiring. Consequently, as you are monitoring, you stop sizing up the position or even reverse course. This is what I mean by "Bayesian Updating," which is the systematic updating of probabilities based on the cumulative conviction you have developed vis-a-vis the valuation of the security.

If you are a value investor, you are usually fighting momentum. Scaling into a position where the psychology on the stock is negative, but valuation is cheap, is usually a good thing to do, because on average the psychology remains negative for some time. If you haven't taken a full position right away, it can help you stick with a stock that isn't working and lower your cost basis (or raise it on a short).

If you are a generalist and/or unfamiliar with an area you haven't followed consistently for a long time period, it's easier to make a mistake on the business. Scaling-in gives you a chance to continue to monitor whether you are right about the business's prospects in the short-term and long-term. I find when I've seen a company report a few quarters after owning it, I get a much better sense for whether I'm right. By then, I've seen two quarterly reports, usually spoken with the management team a few times, done lots of follow up work, adjusted our model a few times, and hopefully had a chance to attend a trade show and talk to people in the business more.

It feels different when you own or are short a stock than before you enter. Most people feel like they are missing out when they don't own something, and then when they own it they start to recognize the risks more acutely. When selling, making continuous small decisions takes the pressure off, because you don't have to make big all-or-nothing decisions. When you make a big decision, it is more likely to come from emotion. However, if you decide repeatedly, it's more likely to be well-reasoned and not based on one or two data points.

As discussed above, I find this helpful because of my tendencies to: 1) rush into new positions, and 2) be too timid to size up positions all at once. If you're just sizing up a position a little at a time as you get confirming data points, it's easier psychologically. That said, if you've followed a company a long time and know it really well, there will be times that you will size up a position more quickly. Obviously the closer you are to having "perfect information," the better a quick aggressive decision will be. However, I've found that these situations are few and far between, because you are constantly dealing with great uncertainty. Making slow methodical decisions generally leads to better outcomes.

Risk Controls

I think the best risk controls you can have are: 1) exiting when you think you are wrong on a position, 2) diversifying to a greater degree than is necessary (at least based on academic studies), 3) having valuation on your side on your positions, i.e. not owning stocks that are too expensive or shorting stocks that are too cheap, and 4) having some cash on the sidelines or some shorts that can protect your downside when the overall market is going down. I've been a good short seller over a long time period, and I prefer, in most environments, to be fully invested and protect downside with shorts. I think the best short sellers ultimately break-even over time or make smaller amounts of money. Shorts create equity for you in down markets, which gives you capital to invest when markets are depressed – the value of this is hard to measure, making the idea of breaking even on the short side more appealing. A short seller who can break even in a bull market effectively creates a free put option for bear markets. It also helps psychologically in down markets, because it reduces the drawdown for both you and your investor base, leading to the ability to think more clearly about the risk/reward of buying when markets are down. For those of you that have suffered through some bad years on the short side, hang in there, it is not time to abandon it now.

The best risk controls are proactive. Limiting risk associated with any business risk factors to a portion of the portfolio (we plan on limiting factor risks to 25% of the portfolio) should help with the sustainability of the portfolio in the long term. For instance, if you had a lot of exposure to domestic companies in the U.K. during Brexit or Chinese companies during late 2015/early 2016, even if the bets were ultimately right, the portfolio suffered significantly from these events. This too is a balancing act, as usually you want to make active bets on certain factors, such as betting on countries with cheap stocks or industries that are extremely depressed.

I find when I'm losing money that cutting a little where I'm getting hurt the most is psychologically helpful. If you are suffering a meaningful drawdown, cutting helps you feel like you are doing something, even if nothing is in many cases a better thing to do. Blue Grotto's plan is to cut 5% if we experience a 6% drawdown; a 5% cut if we are 150-175% invested really is not that meaningful to the overall portfolio, but it helps psychologically, especially because we'll be cutting where there are problems. I find that when I cut a position, I think more clearly about it afterwards and can always return to it out of the heat of the moment. Conversely, I find when you sit in a position and have been hurt significantly in it, you tend to trade it poorly thereafter, which is something I've observed in other investors as well.

Bringing it All Together

There are some factors, like whether you are a good business analyst if a fundamental investor, that are essential to being a good investor. However, there are other factors, like how you deal with situations emotionally or how you deal with risk, that you can adjust your process to account for. For instance, if you are risk-seeking set up a process to slow yourself down and vice versa. It's important to recognize your strengths and weaknesses as an investor and adjust the way you do things to account for the weaknesses. If you're emotional, set up a process that prevents you from trading on emotion. I think part of what has made me successful is my willingness to take a contrarian viewpoint. However, I have also come to recognize that it can be a weakness at times – for instance I tend to sell winners too early, buy stocks that are down too early, and short stocks at new highs too often. Hence, a scale-in or scale-out process to some extent protects me against this tendency or at least provides a counterbalance to the extent it is a weakness.

While having a behavioral edge in the markets is hard, I've learned through a lot of experience my own strengths and weaknesses and how to adjust for them. By being brutally honest with myself always, taking an outside and inside view on situations, and by effectively triaging to focus on situations that fit a mold that has worked for me in the past, I have increased my investing capabilities over time. Boiling things down to what matters and being creative in finding investment ideas are natural strengths I've harnessed. In some situations, I need to slow myself down, while in others I need an extra push to make sure I'm maximizing bet sizes on winners. Knowing all of this is a function of experience and I've had the good fortune to spend way more than the 10,000 hours required for mastery working out all the kinks.

I hope you've enjoyed this letter, please reach out if you have questions or feedback.

Sincerely,

Ben Gordon, CFA

Founder and Portfolio Manager

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