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Be prepared to win some and lose some **28/06/10**

The past tells us nothing at all about the future, even though many of us think it does and we go on to make investments accordingly. Imagine if we asked all investors in New Zealand to perform a random task like flip a coin repeatedly.

After many repetitions, a small portion of this population could appear to have remarkable results. After 10 consecutive coin flips, one investor might have flipped 10 heads in a row. This investor would be seen as somewhat remarkable, even though 10 heads in a row is no more or less likely thank any other particular sequence.

The investor who flipped nine heads and one tail has a sequence that is just as unique as 10 heads in a row. However, to many people, his sequence would not seem anywhere near as exceptional as 10 heads in a row.

If each head were to represent a winning stock pick on the sharemarket the person with 10 heads in a row would probably be hailed an investment genius.

Even though randomly picking winners can be largely accidental, we tend to confuse luck with skill.

Meir Statman, a finance professor at Santa Clara University says “people are often tricked, mainly by the architecture of our brains, into thinking that things that happen at random are actually happening by design”.

When people buy stocks, they think they are playing a game of skill. When the stock goes down rather than up, they think they have lost their knack. When the stock goes up, they think they have been clever. They should take heart. When the stock went down, all they lost is luck, and next time it goes up, they should remember that was luck too.

My own view is that investing involves a combination of luck and skill, but I do acknowledge that investing is m ore an art that a science, and random events and influences are forever present. So if the average investor can’t distinguish between luck and skill, and markets will continue to behave randomly, what is an investor to do?

The first piece of advice is to be skeptical. If we think twice before every investment decision and are prepared for the possibility of and unlikely event becoming likely, we will probably make better decisions. That is not to say that we should all be pessimistic and focus on small probability events why worry about what you can’t foresee? But we should be prepared.

Diversification can help – it doesn’t make sense to have 20% or 30% of your portfolio in one particular asset when you know that left-field events can and do happen. Pay attention to what’s happening around you, but try to ignore the day-to-day movements in share prices. They are more likely to be random movements than part of an overall price trend. Sometimes, ignorance can indeed be bliss.

And, most of all, understand that sometimes things go wrong and it is OK to make some mistakes, as long as you have some wins along the way too.

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