Key Questions

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How Do You Know When You're Wrong?

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It's often impossible to know, and thus remaining humble is a critical element to one's long-term investment success.

The word "humility" originates from the Latin word humilis, which may be translated as "grounded" or "from the earth" since it derives from humus (meaning "earth"). It is also closely connected with the word "human," which naturally prompts the question: "To be human, does one need to possess humility?"

According to many philosophers and religious leaders throughout the ages, one would answer affirmatively as humility is commonly seen as a virtue. Similarly, within business circles, research suggests that humility is an element of effective leadership. For example, corporate strategy expert and bestselling author Jim Collins found that successful leaders "possess humility and fierce resolve."[1]

Curiously, in the investment business, humility is practiced inconsistently in my view. In meetings with hundreds of investment professionals over the course of my career, I have frequently encountered an accomplished investor who, after experiencing a sharp decline in an asset s/he purchased, characterized the experience in the following manner: "My thesis wasn't flawed. I was just early." Or stated more acerbically: "I am not wrong. The market is wrong."

Such perspectives are understandable, but I generally found them unsatisfactory: They usually came across as dismissive. To me, occasionally being wrong comes with the territory; to be wrong is to be human. Making mistakes, so long as they are manageable and recoverable, are great teachers, and when investors make an error, the greatest mistake would be to dismiss it and avoid trying to learn something.

Moreover, it is the feeling one has when s/he commits an error that has far longer-lasting effects than the mistake itself for it typically alters how one thinks and acts in the future. In the words of a notable author: "Studying history makes you feel like you understand something. But until you've lived through a mistake personally and felt its consequences, you may not understand it enough to change your behavior."

One of my own and most recent episodes of being fed a hefty helping of humble pie was served to me by my longtime friend Pete, who I introduced our readers to a year ago.[2] To refresh, Pete and I have known each other for over twenty years, and despite having held a successful career in the healthcare sector, Pete's investment track record has been mixed, putting it charitably. (He is a longtime friend, after all.)

Around this time last year, Pete excitedly told me about a purchase he had just made — a stock that he bought at a price of roughly $2.50/share. Prior to his purchase, the stock had zoomed from under $1/share, and Pete felt it had enormous upside potential, with little/no downside risk.

At the time, I viewed Pete's decision as being detached from logic. I furthermore equated Pete's behavior with speculation, not investing, as his selection seemed premised more on momentum (i.e., the stock had already gone up and therefore it would continue moving up) and less on fundamentals such as the company's financial strength (weak), its industry prospects (even weaker), and the capabilities of its management team (unclear, as many of the executives were new to their roles).

Up until this past spring, the stock oscillated between $1 and Pete's purchase price. And then, like a thunderclap, the stock rocketed higher by over 500%. As it turned out, the outlook for the company has, at the margin, brightened on positive developments with respect to COVID-19 and the faster-than-expected reopening of the economy.

Moreover, the company smartly used the surge in its stock to raise capital by issuing shares and modestly repair its stressed balance sheet.

Thus, while I'm not a buyer of the stock, I concede that I may have been wrong. For now. The company still faces formidable challenges in my view, and for this reason, combined with the unbridled enthusiasm expressed by others, I remain on the sidelines and a firm skeptic.

It is conceivable, however, that Pete and I may both be right. Over the last several months, he clearly benefitted from the stock's swift ascent, but if business conditions reverse and the company's competitors take actions to reassert themselves, the gains in Pete's stock may prove fleeting. This brings me to the answer to my question: "How do you know when you're wrong?"

In truth, without sufficient attempts or time by which to assess success or failure, it is nearly impossible to know for sure. Pete, for example, has only owned the stock for 12 months. Had he bought the stock five years ago, his investment would be lower by nearly 90% despite the recent surge.

The lesson here is that investors should not understate the importance that luck plays with respect to their financial fortunes and our lives as a whole. Using sound judgment, staying attentive to detail, employing patience, and correctly applying pattern recognition skills are hallmarks of successful investors. But luck can also hold significant sway, and thus remaining humble is equally critical to one's long-term investment success.

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Source:
1 Collins, Jim (2001). "Level 5 leadership: the triumph of humility and fierce resolve". Harvard Business Review.
2 See our Key Question article: "You Bought Which Stock?" (June 15, 2020)