Kopion Asset Management

Process vs. Outcome

The result of one particular game doesn't mean a damn thing, and that's why one of my mantras has always been "Decisions, not results." Do the right thing enough times and the results will take care of themselves in the long run.
-Amarillo Slim

Friday, July 8, 2011

Dear Kopion Clients,

Kopion enjoyed a very good first half of 2011, returning 10.9% before fees and 10.4% after fees. The S&P 500 and Russell 2000 returned 6.0% and 6.2%, respectively. It is nice to get off to a good start, but this is only six months of results which limits its meaningfulness. Indeed, as suggested by the quote above, focusing on short-term results can be counterproductive, which is the primary subject of this letter.

We live in a world that focuses on results, and this is mostly fair because results are often the direct consequence of our actions. In some cases, however, results also involve an element of chance which distorts the picture, similar to radio interference. These areas are called "probabilistic fields," and baseball offers a good example of one. Over the course of a season, a baseball player will have hundreds of times at bat with the circumstances varying each time (i.e. pitcher, number of outs, bases occupied, home / away, morale, etc.). If you only focused on a few games, it'd be easy to draw the wrong conclusion about his skill as a batter because you might be looking at a set of particularly lucky or unlucky swings. Consequently baseball fans refer to his batting *average* since this metric captures his performance against a wide range of circumstances. Importantly, batting averages are a natural outflow of the batter's aptitude and training; a disciplined, well directed training regimen is a good "process" through which to achieve more hits. Nonetheless, each at-bat experience will vary and could be classified according to the matrix on the right[1]:

	Good Outcome	**Bad Outcome**
Good Process	Deserved Success	Bad Break
Bad Process	Dumb Luck	Poetic Justice

For example, a sloppy batter that hits a home run when the pitcher is tired and having a bad day is benefitting from "dumb luck," even though he's had a great outcome.

Conversely, a disciplined athlete who strikes out at the hands of an exceptional pitcher is the victim of a "bad break." With enough time, however, the quality of their "processes" will prevail.

And so it is with money management. Managers who make thoughtful decisions will sometimes experience mixed results, but their good processes should lead to favorable performance over the long-term. The opposite is also true. Unfortunately, looking past individual outcomes is at odds with human nature, and there are two primary mistakes that can flow from this. The first mistake is to place too much weight on recent experience. A tragic example of this occurs during bear markets when some investors begin to extrapolate the declines in their portfolios. This leads them to believe that their portfolios are headed for zero and will motivate them to sell out at the bottom. The second mistake is to place too much weight on the success or failure of any particular stock. A few years ago, my wife demonstrated how easy it is to make this mistake when I proudly showed her our portfolio, and she immediately asked me about the one position that was in the red instead of noticing the overall gains that I had achieved. (She not only grew up as the daughter of a value investor, but she married one too. Clearly, anyone can make this mistake!) I should point out that while these two examples use negative outcomes, it is also possible to focus too much on positive results. For example, I once met a portfolio manager who touted his successful stocks, but his mediocre record indicated that he wasn't telling me about his less flattering ones.

Kopion has a well defined decision making process that keeps me focused on how companies are valued relative to their long-term prospects. This is logical since their earnings several years from now will generally determine their stock prices several years from now. This multi-year vantage point also serves as a pair of emotional guard rails that keep me from being whipped around by the month-to-month movements in stock prices. In some cases, such as 2007 and 2008, it's even necessary to look beyond annual fluctuations—"looking across the valley," so to speak. This approach is not a guarantee of success, but it is intellectually, historically, and academically sound.

Learning to focus on making good decisions instead of individual results is one of the most important lessons that I've learned during my nine years in money management, and I'm hopeful that it will prove helpful to you as well. It's also a good reminder that I'll inevitably have some setbacks, both in terms of individual stocks and seasons. While these will be uncomfortable, my process has led to good overall results thus far, and I am hopeful that it will continue to yield a good batting average in the future.

Best Regards,

Terry Ledbetter, Jr., CFA

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[1] J. Edward Russo & Paul J.H. Shoemaker, Winning Decisions.