

# The Perspective

Rational, independent thinking™

## Better Than Average

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Silver Heights Capital Management Inc. is a discretionary investment counsellor.

We manage money for affluent families, foundations, and select institutions. We are focused on preserving our clients' capital and growing it over time.

We utilize a rational and rigorous process to find, analyze, and select investments for our clients.



[www.SilverHeights.com](http://www.SilverHeights.com)



## Better Than Average

We're all human.

No one likes to think of themselves as inferior. We've all heard about the study of people's perceptions of their own driving ability: upwards of 90% of respondents rate themselves as above-average. While we may all laugh at this result, the phenomenon of illusory superiority has implications when it comes to investing.

Notwithstanding the growth in popularity of passive investing, active investors often impair their results with unrealistic perceptions of their own capabilities. Usually, this sort of inflated self-perception is more prevalent and longer-lasting in less-quantifiable pursuits. Even with driving, many poor drivers – yes, “the 10%” are out there! – may avoid accidents purely by chance or the diligence of others. In activities with highly-quantifiable outcomes like boxing or chess, lesser-skilled participants are quickly made aware of where they stand in the pecking order.



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Warren Buffett often states that “staying within one’s Circle of Competence” has been a critical part of his investing success.

*“What counts for most people in investing is not how much they know, but rather how realistically they define what they don't know.”*

Warren Buffett

Many aspects of investing are subject to the perils of our rose-coloured perceptions. Let’s tackle one investing tenet of ours that we believe is not given enough consideration by most investors.

## Visions of the Future

Those familiar with our investing approach at Silver Heights know we have a preference for high-quality businesses. The higher the quality of the business, the higher should be its level of profitability. This characteristic being on an investor’s wish list should not be a surprise. However, one of the most underappreciated aspects of higher-quality businesses is predictability, or visibility.

*The higher the quality of the business, the farther out into the future one should be able to look and have comfort that its cash-generating ability will continue.*

Why should an investor care about this?

*The farther out you are able to look – and see positive developments – the fewer decisions you will likely have to make over your investing time horizon.*

We’ve talked about it in the past, but it never ceases to shock us when we see how short-term oriented our industry has become. We like to own great businesses,

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patiently-acquired at good prices, for many years. In contrast, there are large numbers of investors (we would call them speculators) who trade in-and-out of stocks on a daily basis. Think Apple's next product launch will be a blockbuster? Buy the stock before the release of the next quarter's results! Got a hunch that China's GDP growth may be half a point better than others think? Buy some copper stocks!

Regardless of how brilliant an investor may think they are, we would bet that even the most self-confident investor would not be so foolish as to think that they never make mistakes.

We all know that you have a 50-50 chance of calling a single coin flip correctly. If you're given the task of correctly calling two consecutive flips, instead of just one, your chances of success drop to 1-in-4. Your chances of correctly predicting consecutive coin tosses decreases *dramatically* as you increase the number of flips you are attempting to predict.

One coin flips	50%	1-in-2
Two coin flips	25%	1-in-4
Four coin flips	6.25%	1-in-16

*Short of possessing a perfect batting average, the irrefutable reality of statistics works against you in a very concrete fashion.*

How does the math behind guessing coin tosses relate to us as investors? The legendary investor, Peter Lynch, said,

*"In this business, if you're good, you're right six times out of ten.  
You're never going to be right nine times out of ten."*

It would not be uncommon for investors to think "The stock is expensive right now. I'll sell it and buy it back at a lower price later". Regardless of the investment under consideration, you're *tripling* the number of decisions you will be making when compared to simply buying and holding a quality company. Let's say that you are a significantly-better-than-average investor and are right on your decisions 70% of the time. If you need to make three decisions, you'll end up with an optimal outcome 34% of the time. If your success rate is

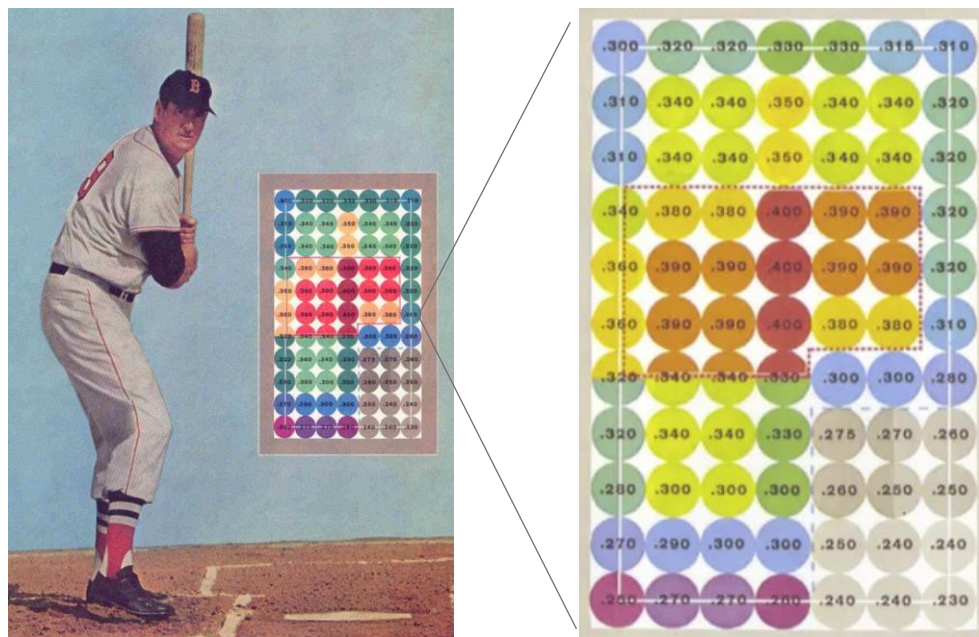


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closer to Peter Lynch's notion of "good" on Wall Street (60% successful decisions), making three decisions will net you an optimal outcome only 22% of the time.

While there are lots of reasons why one investor may have a superior decision-making batting average than another – some people are just smarter than others – we think that one characteristic that helps contribute to a higher success rate is simply the number of decisions one makes. The more decisions you try to make, the lower your batting average is likely to be. If this notion sounds familiar, it's because it's an extension of baseball Hall of Famer Ted Williams' batting theory. Williams figured out that there were certain spots in the strike zone that were better for him than others. He broke it down as follows:



Source: "Science of Hitting", by Ted Williams

By swinging only at the pitches in the best zones, he would achieve a higher batting average: the key to hitting success in baseball was to wait for the "fat pitch".

Unlike in baseball, investing offers the participant the added luxury of never getting called out on strikes. You never need to swing unless you feel it's the right one for you. By being patient and waiting for the best investment opportunities, when circumstances are heavily

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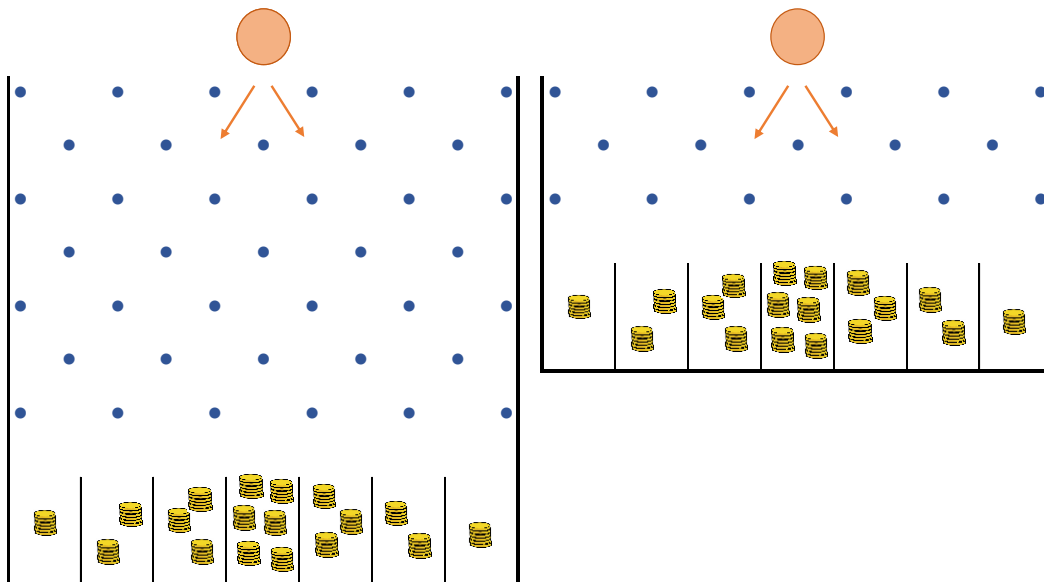
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skewed in your favour, we believe that you're far more likely to have a better "investment batting average" than if you made dozens of buys and sells every day.

On top of these daunting statistics, unless your money is in a tax-sheltered account, the more you trade, the more of your capital you'll be sending to the tax authorities. (If you never sell stocks at prices higher than what you paid for them, then perhaps we should be having another discussion!)

This framework around the number of decisions reminds us of a game that was played on the television game show *The Price is Right* called "Plinko". In that game, contestants were given a plastic disc that they dropped into the top of a vertical board that had pegs throughout. As the disc hit the pegs, it bounced around and eventually fell into various slots at the bottom of the board which indicated the prize for the player. The more rows of pegs, the harder it is to predict where the disc would end up.

**Which game would you rather play?**



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To be clear, we are not advocating “buy & hold” for the sake of holding.

*We simply believe that an investing approach that requires fewer decisions is more likely to yield better returns than one that requires more decisions.*

High-quality businesses offer better long-term visibility and require fewer decisions during their ownership, thereby enhancing the chances that we will enjoy an attractive long-term outcome.

*An investment approach focused solely on statistically-cheap assets implicitly embeds a greater trading component (i.e., more decisions) than an approach that focuses on quality assets.*

When you think about what strategy you, or your financial advisor, should adopt, ask yourself the simple question:

*How often will we need to be right when we make decisions?*

If your chosen strategy involves a lot of in-and-out trading, you should be aware that you are placing an *enormous* reliance on having a batting average that may be impossible to achieve.

There are other ways to further reduce the quantity of decisions you need to make. Besides seeking high quality, we hold relatively concentrated portfolios: we think we can understand a handful of companies, but we don't think we can deeply understand 100 of them. If you adopt this mindset of fewer holdings, there is an added benefit of mental focus. Knowing you will invest more in each investment will force you to gain a deeper knowledge of each. This should result in a better decision-making batting average. It's a virtuous cycle that, we think, produces tremendous results.

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People like to say “The house always wins” when talking about casinos. That catchphrase is merely an outcome of the mathematical fact that casinos play the statistical odds that are in their favour *over a long period of time*. Do yourself a favour and put the odds on your side by using an investment approach that requires fewer, rather than more, decisions.

Sincerely,



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