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TAKING STOCK: REVISITING THE LOSER'S GAME

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Some of you may have read the article "The Loser's Game" written in the 1970s by Charles Ellis,[1] which has occasionally been cited in various financial media. Mr. Ellis brought together a number of important findings that helped us understand general strategies for performing well against our peers, which were dependent upon our skill set and the nature of the competition. His findings are still very relevant for us today.

One of Mr. Ellis' examples included a study performed by Dr. Simon Ramo regarding the game of tennis. Professional players would win the game by scoring more points against their opponents, and this was termed a *Winner's Game*. Amateur players, on the other hand, would not beat their opponents by scoring points, but would actually beat themselves by conceding points, and this scenario was referred to as a *Loser's Game*. In other words, professionals would win against other professional opponents by superior skill, while the amateurs would lose against their amateur opponents by making more mistakes. Moreover, amateurs would take more chances against other amateurs in an effort to win, which actually caused them to make even more errors (this was therefore a much less effective strategy than a more conservative game plan). The main message was that approaches to the game are very different dependent upon the ability of the players—victory in one circumstance is determined by the skill of the professional (a winner), while victory in the other is determined by the mistakes of the amateur (the loser).

Many other games and competitions also involve numerous variables and provide opportunities for potential mishaps, such that it is easy to hurt performance if one is not very adept or expert at it. Mr. Ellis extends his discussion to areas such as warfare, politics, card games, other sports (such as football and golf), and even to the investment business. Interestingly, the *Winner's and Loser's Strategy* can sometimes even change during the same competition. Mr. Ellis cites prize fighting as one example, where fighters often try for a knockout early in the fight (this employing the Winner's Game mentality) but if this goal is not achieved, they revert to a Loser's Game strategy of merely surviving each round and hoping to win out through better endurance.

An extension of the above analysis is that one should avoid making mistakes when the competition is fierce and of equal ability, for it is also a Loser's Game. Being able to win the Loser's Game requires a substantial edge, which most people will not be able to accomplish or demonstrate under such a strongly competitive environment.

Mr. Ellis' focus in the article was ultimately on the investment business. He cites how the investment industry has changed in its character as it evolved over the decades from the 1920s to the 1970s. When the market environment was conservative (as it was in the 1930s and 1940s), members of the investment industry focused on such themes as preservation of capital and safety (which we can view as a Loser's Game mindset of not taking chances and making mistakes), and this set the stage for the Winner's Game and the bull market of the 1950s. The new possibility of making "big money" as highlighted in the 1950s bull market, attracted some of the best and brightest people (the winners) into the investment business of the 1960s. However, the environment eventually self-destructed as many investment funds were established and even more talented people entered the investment industry, resulting in diminishing returns and the set-up of the Loser's Game of the 1970s (i.e., these winners were eliminating many of the market inefficiencies and any mispricing, resulting in fewer opportunities to benefit from the errors of others). One could be perceived as competing against amateurs (the losers) in the 1930s to 1940s creating a Winner's Game environment, but in the 1960s and 1970s (when the article was written) one was competing against the professionals (the winners) setting up a Loser's Game. To sum up Mr. Ellis' analysis of the investment business as he saw it evolve, in a Winner's Game, a professional can make great investment returns if the competition consists mostly of amateurs or less-skilled professionals. In a Loser's Game however, where one is

competing not against amateurs, but against many other professionals (winners) of similar ability (this time not only amateurs of similar ability), the opportunity to make great investment returns through superior skill is limited. In a Loser's Game, one may actually want to be defensive (and thus make less mistakes) in order to survive, since a slip-up can be very costly as other skilled professionals are there to take advantage of it.

Mr. Ellis did not conclude that in an investment industry dominated by very talented investment professionals we should therefore consider only passive strategies—rather the task of identifying whether an investment professional or manager had the necessary skill to beat the market was becoming much more difficult, and that investment management firms should acknowledge this reality. And if such a skilled investment manager cannot be identified, then a passive strategy could be a consideration.

Mr. Ellis' concluding comments on how to win the Loser's Game in investment management were also very useful and insightful. His remarks were as follows:

(a) Play your own game and let the others make the mistakes;
(b) Know what you are good at and keep it simple;
(c) Concentrate on your defenses; and
(d) Do not take it personally (i.e., it is just becoming harder to succeed and it is not your fault).

Interestingly the themes cited in (a) to (d) still resonate today and help to explain why we have some of the current global financial and economic problems.

HOW THE WINNER'S AND LOSER'S GAME APPLIES IN OTHER AREAS

Mr. Ellis' concluding remarks do shed important light on where we are currently in the investment and financial industry, and how we arrived at some of our current global problems and emerging trends. If we were in a Winner's Game environment, we would primarily only need to focus on (b) to win. But due to the evolution of our various industries to one of intense competition and involving many sophisticated players, (a) to (d) now have to be considered. A simplified view of some recent developments could include the following:

The Financial Crisis of 2007-2009—The drive to be a winner can be one of the reasons the financial crisis developed. The desire to achieve investment and financial performance that was better than the competition was a motivating factor to apply new approaches. Those who introduced these ideas, strategies or products early in the business or product cycle benefitted greatly. But the assessment of whether one truly had a skill in that particular investment or product area was often not properly done. Risk management, compliance, product due diligence and other proper analysis and safeguards were not often in place, violating (a), (b) and (c) above. The ultimate winners in the financial crisis were those who more strongly focused on (b), but the temptation was too strong to do what everybody else was doing as mentioned under (d), so many organizations and people suffered.

Hedge Funds—The initial successful performers in the hedge fund arena tended to be those who best understood the principles of (a) and (b) above. In a fund-of-hedge funds approach, the overlay hedge fund manager was also looking for those who were taking full advantage of their abilities to perform in (a) and (b). Unfortunately, the major mistakes occurred in the areas of (c). It was also becoming apparent as time went on, that many hedge funds were in the (d) category of not being truly able to succeed against other players, but refused to admit it. Some may have then undertook more risk and leverage in order to keep the extra edge and to portray greater skill, but eventually it led to their demise.

Career Progression—Going back 30 years or more, one could obtain a good paying job simply by having a university degree or a set of credentials. A resume only needed

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to list the ability to perform basic day-to-day duties in order for a candidate to be seen as a good employment prospect by an employer. Today, with the intense competition for positions and the greater proliferation of education and credentials among job candidates, job seekers often get coached about the need for differentiation, branding, performing a self-assessment of skills, building interviewing skills (including not saying the wrong things), citing personal success stories in a resume, and looking for ways to stand out from the crowd. Interestingly these areas do follow (a) to (d) above. These attributes are also becoming important for those wanting to keep a job.

***Business Diversification*—**We have seen companies which have done very well in their core businesses. But they then would want to expand into other business lines, only to find later that this was a bad idea and then would exit at a financial loss. These companies were doing the opposite of that mentioned in (a) and (b). The survivors learned from their mistakes and moved back to a basic strategy.

***Technology*—**We have witnessed great change in the area of technology the last several decades. The fast pace of development, the proliferation of new products, the short time in which a company can stay on top, and the rapid speed at which a competitor can come up with a similar product (and better), can make one feel rather dizzy. The application of (a) and (b) are rather interesting, because what a company was good at yesterday may not be true today, and the environment can change dramatically in a matter of months. Playing defense as mentioned in (c) also becomes important, because the longer it takes for the competition to match with a similar product, the more successful the leading company will be (and these days that still usually spells significant profits).

Outsourcing—Some companies unfortunately never do a proper internal analysis or never want to fully incorporate the principles identified in (a) to (d). The corporate leadership may feel embarrassed to admit that the company cannot do everything well, especially if it has a lot of resources and staff. But outsourcing certain tasks can result in cost savings and better quality. It can also result in improved corporate performance.

THE WINNER'S AND LOSER'S GAME TODAY IN INVESTMENT MANAGEMENT

There has been a regular debate between active and passive investing for several decades now. Some are adamantly opposed to active management, while others attack passive management. We have had a proliferation of exchange traded funds (ETFs) which accommodate those who do not want to make asset manager or security selection decisions. On the other hand, it is important to realize that we can never expect investment performance to be above average if we just stay passive. For certain sectors and themes, there are investment managers who do appear to have skill to outperform the market. Sometimes advantages or disadvantages can be attributed to geography, motivations of the investment managers, their technology and skill sets, investment research capabilities and techniques, the newness of a strategy, and even the size of the organization. The choice between active and passive strategies can lead to a discussion about the perceived investment performance and cost. This is where consultants and investment advisors can bring additional value to an investment relationship.

CONCLUDING REMARKS

Mr. Ellis' article is still of relevance since it cites various themes and observations which have not changed. Interestingly, his points also have major implications for the competitive climate we have in many industries today.

Companies are pushed to achieve better results and they are not always able to deliver them. They feel a pressure to do something differently while not always being capable to deliver added performance, and they may not fully real-

ize their limitations. This generates a danger, in that risk becomes introduced because the persons and companies involved had not truly addressed their strengths and weaknesses and had not established processes to deal with them; in other words they failed to adequately consider the points outlined in (a) to (d).

Similarly, at the individual level, persons may have not truly understood how to adapt to an employment marketplace that has been more competitive. They may adopt tactics that worked years ago but which are no longer effective today. As a result, their career positions in various organizations are in jeopardy, and they do not realize how they need to adapt in their chosen field and redefine their image, to find or retain positions in a new industry environment.

Winning in a *Winner's Game* or *Loser's Game* does involve a proper assessment of the competitive environment, a thorough and accurate self-assessment, and playing from your strengths while defending against your weaknesses. It is a very interesting way to view the world, but it is not truly complicated if one wants to maintain and advance in the various environments that exist in the global marketplace today, but rather it just involves more work.

END NOTES

[1] Ellis, Charles D. "The Loser's Game", *Classics: An Investor's Anthology,* Ed. Charles D. Ellis with James Vertin, Homewood: Business One Irwin, (1989) 524-535. Reprinted from *The Financial Analysts Journal*, Vol. 31, No. 4, July/August 1975, 19-26. New York: Financial Analysts Federation

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