We All Make Mistakes

October 7, 2019

Human beings are a diverse bunch, but we all share a few things in common. For example, we all make mistakes – every day, and in just about every area of our lives. Some of these mistakes are inconsequential, like unevenly spreading a fitted sheet over a mattress. Others, though, can be absolutely devastating, such as committing a crime or mistreating those we love.

Investing is no different. Some investors have better track records than others, but nobody is perfect. Not Warren Buffett, not Jim Simons, not you or me.

Broadly speaking, investor errors fall into two categories: errors of inclusion and errors of omission.

Let’s focus on errors of omission first. Take Warren Buffett, arguably the most successful investor of all time. For decades, his company, Berkshire Hathaway, has routinely trounced the S&P 500. However, there have been some noteworthy names omitted from Buffett’s portfolio during that timeframe, including (until recently) the famous FAANG stocks and other tech companies that have been among the top performers over the last 20 years. How on earth could the Oracle of Omaha have been so myopic? Well, he would be the first to tell you that he only invests in what he knows. By extension, he doesn’t risk his capital in enterprises whose business models he doesn’t understand, some of which are bound to be winners. If it’s any consolation, the next time you read one of those frivolous articles about how much money you would have made if you had invested in Amazon in 1997, just remember that even Warren Buffett himself missed out on that opportunity.

Errors of inclusion, on the other hand, are much more tangible and easy to quantify. We’ve all held positions that have underperformed; it’s unavoidable when you have a diversified portfolio. Venture capital investing offers a particularly stark illustration of this phenomenon, as this quote from Morgan Housel demonstrates:

Out of 21,000 venture financings from 2004 to 2014, 65% lost money. Two and a half percent of investments made 10x-20x. One percent made more than 20x return. Half a percent – about 100 companies – earned 50x or more. That’s where the majority of the industry’s returns come from. It skews even more as you drill down. There’s been $482 billion of VC funding in the last ten years. The combined value of the ten largest venture-backed companies is $213 billion. So ten venture-backed companies are valued at half the industry’s deployed capital.

Housel’s full article is worth the read, but the point here is that even in the world of venture capital, which is populated by smart, well-educated people, and typically reserved for high-net-worth investors, there are far more losers in a typical portfolio than there are winners. Errors of inclusion abound.

Okay, so all investors make mistakes, whether they are errors of inclusion or errors of omission. Not even the sharpest minds with the most resources are immune. However, all is not lost. You can afford to make a few small mistakes. It’s the gigantic, irreversible mistakes you must strive to avoid.

Say you own a diversified portfolio of large-cap U.S. equities. Will some of those stocks go down in value? Yes, at some point. Is it a mistake to own those that do? Perhaps you could argue that it is. Is this likely to doom you as, over time, the overall value of the fund grows and compounds, and the gains more than make up for the losses? Unlikely.
Now, let’s assume you’re approaching retirement and the majority of your wealth is tied to your company (whether you own it or are employed by it). Some horrible series of events sends the business spiraling downward, and you don’t have time to exit the position before your net worth has been obliterated. Not so easy to overcome.

Or perhaps you own a business and fail to acquire a company because you thought the terms of the deal weren’t quite right. The company you were hoping to acquire goes on to achieve incredible growth. Maybe the missed opportunity doesn’t ruin you, but your error of omission could end up significantly restricting your company’s growth potential and/or competitive advantage.

Obviously, it’s good to avoid investment errors whenever possible. That said, it’s better to focus on avoiding the mistakes you can’t undo rather than focusing on the errors you can’t avoid.

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