Dimensional

A Day at the Races

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Feb 29, 2024

Sometimes it is easy to distinguish luck from skill. Other times, maybe it's not so straightforward.

Let's try a simple thought experiment designed to calibrate our appreciation of the problem. Let's say someone calls 20 coin tosses in a row correctly; is that luck or skill? I think we'd all agree it was luck. However, if a champion darts player hits 180, we'd probably say it was attributable to their skill and countless hours of practice. Winning at the roulette table? Luck. A professional player winning at poker? Skill, and some luck. Me hitting a hole-in-one in my first, and only, game of golf? Pure fluke—as evidenced by the rest of my scorecard. Tiger Woods getting a hole-in-one? Some luck, but he certainly has the ability to get near the pin consistently, so skill definitely plays a major role as well.

What about fund management? If a fund manager is highly successful, is it because they are skilful enough to zig when the rest of the world zags? Are they simply lucky with their calls? Or some combination of both? Successful managers would certainly want to lay claim to being skilful. Just like Tiger Woods getting on the green, it is, after all, what they are aiming for. And, having enjoyed the financial rewards and elevated social status that accrue from a successful track record, they are hardly going to be incentivised to admit to their investors that, at the end of the day, they just got lucky.

The question of luck vs. skill has intrigued academics for decades, and unfortunately for fund managers, the results of their studies find investment outperformance to be largely attributable to luck rather than evidence of superior skill. Indeed, as far back as the 1960s, Michael Jensen (1968) produced one of the first empirical studies to challenge the prevailing notion that professional fund managers could consistently outperform the market through security selection and market timing. The main conclusion of his study was that the average actively managed mutual fund was unable to outperform a benchmark portfolio that was adjusted for risk, even before taking into account fund expenses and fees.

In a more recent attempt to disentangle the question of luck vs. skill in mutual fund performance, Fama and French (2010) drew a similar conclusion. Specifically, a small fraction of the managers in their study did in fact appear to achieve returns that were not merely due to luck after accounting for fees, expenses and risk exposure. However, there were fewer of those managers than would be expected by random chance alone.

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But if, as the evidence appears to show, outperformance is more attributable to luck than skill, why is it that some people still want to believe so fervently that it is otherwise?

The behavioural finance literature reveals the influence that psychological and emotional factors can have on investment decisions, often leading investors to overestimate the role of skill. This overconfidence can be partly explained by our innate desire for control and our preference for narratives that attribute outcomes to human agency rather than to random chance. For some, it's comforting to think that with enough knowledge, expertise or information, one can consistently beat the market.

When you do experience success, it can prove to be a heady cocktail. I experienced this myself when, a few years ago, the team went for a day at the races. By pure luck, and much to my own astonishment, I managed to pick the winner of several races in a row. Despite my strenuous efforts to convince them otherwise, my colleagues started to suspect I had some secret knowledge or skill that would explain my mounting pile of cash. Indeed, some of them started to offer to buy me drinks, or a share of the winnings, if I would confide in them with them my picks for the remaining races.

Of course, my winning streak came to an end—and with it my reputation as a tipster. The team realised what I had been telling them all along was true: I had just gotten lucky. But when you are riding the wave of good fortune and enjoying its rich rewards, it takes some measure of self-discipline to resist the thought that you might indeed have the Midas touch. You start to experience why it might be so tempting to blur the lines.

Understanding the balance between luck and skill in fund management is crucial. Investors and advisers alike should approach fund performance with a healthy degree of scepticism. We believe the best approach is a systematic one that ensures you are not paying for luck disguised as skill but, instead, making decisions informed by sound theory, empirical evidence and a robust investment philosophy. Whilst it may lack the drama and excitement of a day at the races—or the fund management equivalent—this approach perhaps has a higher probability of delivering a successful, rather than a stressful, investment experience.

Fama, Eugene F. and Kenneth R. French. 2010. "Luck versus Skill in the Cross-Section of Mutual Fund Returns." Journal of Finance 65, no. 5: 1915–1947.

Jensen, Michael C. 1968. "The Performance of Mutual Funds in the Period 1945–1964." Journal of Finance 23, no. 2: 389–416.

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