

ECONOMICS

Don't ignore luck

[Author image](#)

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trictly speaking, this was silly (as he knows). Ashtead shares will rise or fall regardless of your tax position, and it's better to have a taxable gain than a loss, so your tax position shouldn't determine your stock-picking decisions.

And yet my friend's decision made him money: his remaining Ashtead shares have risen 20 per cent since then.

Which is an example of how irrationality sometimes works in our favour. There's a big difference between being right and being rational. You can be rational but wrong: calling heads is a rational choice even if the coin turns up tails. And you can be right but irrational if (say) your stock selections are based upon astrology and you get lucky.

I suspect the latter has been the case for some buyers of crypto-currencies and before that gold. Buying these because you believe “fiat money” is doomed is irrational: there’s no firm basis for the belief and if “fiat money” does collapse it’s not clear that anything will protect you simply because investors’ property rights might well go the same way as paper money. Nevertheless, scare stories about “fiat money” have made profits, at least until the last few days (This is of course not to say that all such buying has been irrational: they have been other reasons to have bought them.)

Often, though, the distinction between being right and being rational is a fine one – so fine as to be imperceptible to outsiders or even ourselves.

Take momentum investing. We’ve abundant [evidence](#) from around the world that this [works](#). It’s a rational strategy – if that is you are doing it on the basis of this evidence and with an exit strategy such as the rule to sell when prices fall below their 10-month average. But it’s easy to be an irrational momentum trader if you are buying rising shares simply because they’ve grabbed your attention or because your friends and colleagues are buying or because you are swept up by whatever story is powering the bubble.

The returns to the rational and irrational momentum trader will however be the same during the up-phase of an asset. Chasing [noise](#) can sometimes pay off.

Or think about what happened last November. Holders of bombed out stocks such as **easyJet (EZJ)**, **Carnival (CCL)**, **Cineworld (CINE)** and **Rolls-Royce (RR.)** made a fortune as these rose 70 per cent or more in the space of a month. But were they rational? In many cases, no. One aspect of momentum is that loser stocks often carry on falling, and John Campbell at Harvard University has shown that distressed stocks on average do [badly](#). Rational investors should therefore have been wary of such shares. Yes, some had light positions after very diligent research, but others, reasonably, avoided them. Instead, many of those who enjoyed November’s bounce were those who had clung onto losers and got bailed out by the discovery of a Covid vaccine. They were right, but not necessarily rational.

But again, profits were the same for the rational and irrational alike. We can’t distinguish those who were irrational but lucky from the genuinely good investor.

This inability is, however, dangerous for investors.

It’s easy to convince ourselves that what were lucky calls were rational ones: Arvid Hoffman and Thomas Post at the University of Maastricht call this the self-attribution [bias](#). One [study](#) has found evidence of day traders in foreign exchange markets “attributing random success to their own skill.” This can cause us to become overconfident and so take more risks at bad odds. Joseph Stalin is perhaps not best known as an investment advisor but he had a point when he warned: “People not infrequently become intoxicated by successes; they become dizzy with success, lose all sense of proportion and the capacity to understand realities.”

But we also tend to attribute skill to other people when in fact there’s just luck. The most spectacular evidence of this comes from [experiments](#) in Singapore and Thailand by Nattavudh Powdthavee and Yohanes Riyanto. They have found that people are happy to pay for other people’s predictions of the toss of a coin if those people had called previous tosses correctly.

Absurd as that may sound, investors do a similar thing. Christoph Merkle at Aarhus University shows that they “[confuse](#) risk taking with skill” and so entrust their money to bad fund managers who had simply got lucky. Andrew Clare and Nick Motson at Cass Business School have found the same thing. Investors, they [say](#), “lose money because they buy unit trusts after short periods of good performance, failing to see that this can be due to dumb luck rather than to fund managers’ skill.” In fact, investors around the [world](#) make this [mistake](#), piling into funds after just a few months of decent returns even though these might well be due to pure [luck](#).

None of this is to say that we must distinguish between luck and skill. Given the impossibility of doing so in many cases, that’s a counsel of perfection. We should, though, remember that in a world of volatile returns luck plays a large part and so we should be wary of seeing skill where none actually exists. And this applies to our own performance as well as others’.

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