

Three "Critically Counterintuitive" Rules of Investment

A few years ago, I came across the aptly named concept of the "critical counterintuitive." It is "critical" because little else really matters. It is "counterintuitive" because the world works in ways almost exactly opposite to the way you think it does.

The "critical counterintuitive" is everywhere you look. The "nice guy" who takes the flowers and candy route hardly ever gets the girl. The smartest kid in the class rarely becomes rich and famous. And the class clowns or ne'er-do-wells who do are sometimes the most unbalanced and unhappy, material trappings notwithstanding.

The investment world also has its share of "critically counterintuitive" rules. And understanding how you can apply them can spell the difference between your investment success -- or utter disaster.

1. Don't Confuse Luck with Smarts

The role of luck in investment success is deceptively subtle.

You may think that investing \$10,000 into one stock that makes you \$1 million would be the best thing that could ever happen to you.

But you'd be wrong.

Having enjoyed such phenomenal success, you'd suddenly think that you'd cracked the code of the markets. The next time around, you bet your house, your car, and your life savings on another "can't lose" investment. Maybe you'd win this time as well. And now, a back of the envelope calculation would confirm that if you do it only one more time, you'd have \$100 million in the bank.

Eventually, however, your luck runs out. Your last investment flops. And since you bet the farm, you not only lost your shirt but also you're deeply in debt. You are worse off than when you started.

Moreover, you also spend the rest of your life trying to replicate your initial trade, telling yourself that you've learned your lesson, and if you do it only one more time, you'll take all your chips off the table.

That's the problem with sudden wealth, whether it comes from a big bet on a stock tip or buying a winning lottery ticket. The statistics bear this out. Almost everyone who wins the lottery ends up poorer five years later than beforehand.

As a wise man once said, "If you win a million dollars, you'd best become a millionaire. Because then you get to keep the money."

The lesson? Understand that if you have ever won a big investment bet, you were at least as lucky as you were smart. But over the long term, there are no shortcuts. Making money on a consistent basis is a grind that is one part "insight" and ten parts discipline."

2. Your Analysis Is Irrelevant to Your Investment Success

The philosopher Friedrich Nietzsche once observed that: "Any explanation is better than none."

I disagree. Sometimes, in the investment world, no explanation is really necessary – or relevant.

Today, we suffer from the paradox of information overload. You can access more information about the financial markets than ever before. Yet, I bet your investment returns have not improved one iota as a result.

Not only do we seem incapable of divining the future, we can't even seem to agree on what happened. Was the credit crunch a result of Greenspan's monetary policy? Bernanke's incompetence? Clinton's "affirmative action" for low-income borrowers? Or was it just a classic mania? We crave explanations because it gives us an illusion of control.

But it gets even worse. Even those Cassandras who got their analysis "right" in predicting the credit crunch weren't able to turn their accurate insights into money for their clients. And truth be told, they weren't that right after all. Gold didn't hit \$3,000 an ounce. The U.S. dollar didn't implode. Treasuries didn't collapse. Analysts who promised to "crash-proof" their clients' portfolios ended up losing more money for their clients than if they had stuck with simple index funds.

The lesson? Successful investors are successful in the long term because they admit their mistakes. As the world's greatest speculator George Soros said: "My system doesn't work by making valid predictions. It works by allowing me to recognize when I am wrong."

3. Your "Intelligence" is Your Biggest Handicap

Warren Buffett famously observed that it takes no more than average intelligence to become a successful investor.

I'd add something to that. I'd say high intelligence is actually a handicap to successful investing.

Here's why. When you are smart, you are used to being 100% correct. You just can't take the possibility of being wrong. So you stick to your guns, even when the market is telling you otherwise. That's why overeducated Wall Street analysts make such lousy money managers. And why hedge fund managers who flaunt their intelligence inevitably flounder.

Think about it this way. If high intelligence were the key to successful investing, top business school professors and economists would be the wealthiest guys on the planet. Instead, the Forbes 400 is populated by dropouts from places like Harvard (Bill Gates) and Stanford (the Google guys). They were guys who never could have gotten a job on Wall Street, let alone teach at a top business school.



INVESTMENT HAT

That's also why poker players make the best traders and investors. They play each hand as it is dealt them. If they get a bad hand, they fold. They play the investment game the same way.

Perhaps that's also why a former Dean of Harvard College, Henry Rosovsky, observed about Harvard students: "Our A students become professors. Our B students go to law school. Our C students rule the world."

After all, it was those C students who stayed up all night playing poker with Bill Gates.

Critically Counterintuitive Lessons

So how can you use these "critically counterintuitive" rules to improve your investment returns?

First, never bet too big on one idea. You may get lucky once. Maybe even twice. But your luck will eventually run out. And if you bet the farm, you are out of the investment game for good.

Second, don't delude yourself into thinking that you have special insight into the market. Bring that attitude to your investments, and you will have your head handed to you. And it's not a question of "if" but "when."

Third, learn to think of your investments like a hand in a poker game. Up the ante when you are lucky enough to get a good hand. But also be prepared to fold -- and to fold often.

But above all, take the advice of a very wise trader who once said:

"Some people are born smart. Some people are born lucky. Some people are smart enough to be born lucky."

Here's to hoping that you were born lucky!