THE TWO TYPES OF ERRORS IN INVESTING

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Life is made up of an infinite number of choices that are neither black nor white but most often, have shades of grey. Thus, every decision of choosing 'A' over 'B' exposes us to uncertainty, and where there is uncertainty, there is a possibility of making errors. It is therefore impossible to go through life without making errors, and thus the saying, 'To err is human'.

Errors can be broadly classified into two categories – errors of **commission** and those of **omission**. Consider the act of driving a vehicle – an error of commission occurs when you drive the vehicle at a speed higher than the specified limit, whereas an error of omission happens when you take a turn without signalling to the vehicles behind you. As the names suggest, an error of commission occurs when you commit an action that should not have been committed, whereas an error of omission occurs when you do not commit a recommended/required action.

Investing, like life, is an exercise in probabilities. Among other things, investors constantly battle between the choices of whether or not to invest in a given business. The error of commission in investing can happen not just in buying a sub-optimal business, but also in cases where a good business is bought at an extreme valuation. It can further surface while selling a capable and high return generating business at an undervalued price. On similar lines, an error of omission is not just in missing out on buying great businesses, but also in not selling a great business at an extreme valuation.

While both the errors are crucial and have negative bearings, we believe that their relative strengths differ in each field. For instance, in activities like lending and insuring (i.e. businesses of banks, NBFCs and insurance companies), the error of commission (lending to a potential defaulter / lending at variable rates while borrowing at fixed rates / underwriting a risk with a high probability of occurrence at low margins) can be more damaging than the error of omission (letting go of some growth). On the other hand, errors of omission could be comparatively costlier for an investor than an error of commission.

This works at all levels, from asset allocation (100% of 10-year capital in fixed income that barely beats inflation and no allocation to equities – an error of omission, or 100% allocation of 10-year capital to equity at very high valuations – an error of commission) to sector selection and even stock picking. Sadly though, a mistake of omission is much more difficult to point out, especially in terms of investing. That's because there's no investment loss since there was never an investment in the first place. Thus, such mistakes go unnoticed and are rarely talked about.

Warren Buffett in his 2007 letter to shareholders hinted at how errors of omission would have cost billions of dollars to Berkshire. ***"To begin with, I almost blew the See's purchase. The seller was asking $30 million, and I was adamant about not going above $25 million. Fortunately, he caved. Otherwise, I would have balked, and that $1.35 billion would have gone to somebody else,"*** he said.

In 1972, the year that Berkshire bought See's Candy, it had roughly $30 million in sales and $4.2 million of profit. 35 years later, in 2007, Buffett noted that sales had risen nearly 13 times to stand at $383 million while profits were up nearly 20 times at $82 million. That means Berkshire was earning nearly three times the cost of its original investment each year.

Similarly, if one looks at the track record of legendary investors, a majority of the portfolio returns come from 10-20% of the holdings (The Pareto principle works in investing too, 80% of the returns come from 20% of the holdings). So, it doesn't matter even if some of the ideas turn bad, but you need to commit (to be in the market) rather than omit.

Investor psychology, however, works in the opposite direction. Tellingly, errors of omission in equity investing is the highest when the markets are at their absolute lows. We have witnessed how most investors had given up on investing in equities as an asset class during the 2001 and 2008 crises respectively. While investors fear the falling share prices as a risky investment during such periods, they fail to recognise that during such times, stock prices more than adequately discount all the risks.

To illustrate our argument favouring commission over omission, we have built a portfolio of 10 stocks which were well discovered and loved by markets during the 2004-2008 bull run. Anyone investing during that period would agree that a layman investor must have had some of these stocks in his/her portfolio. We built the portfolio assuming that all the investments were made at the beginning of September 2008 (ten stocks were bought with 10% weight each), just before the Lehman crisis surfaced, and left it unchanged till date.

Exhibit 1: Illustrative portfolio

		As on September 01, 2008			As on March 27, 2019			Returns	
Holding	**No. of Shares**	**Price**	**Amount**	**Weight**	**Price**	**Amount**	**Weight**	**Absolute**	**CAGR**
HUL	413	241.95	99,925	10.0%	1,680.05	6,93,861	17.4%	594%	***20%***
ICICI Bank	827	120.83	99,926	10.0%	393.30	3,25,259	8.1%	225%	***12%***
IVRCL	674	148.15	99,853	10.0%	0.88	593	0.0%	-99%	***-38%***
Larsen	175	569.34	99,635	10.0%	1,367.85	2,39,374	6.0%	140%	***9%***
Maruti Suzuki	157	634.16	99,563	10.0%	6,522.25	10,23,993	25.6%	928%	***25%***
Reliance Comm	257	388.95	99,960	10.0%	4.57	1,174	0.0%	-99%	***-34%***
Tata Steel	179	556.70	99,649	10.0%	515.90	92,346	2.3%	-7%	***-1%***
TCS	491	203.59	99,963	10.0%	1,968.20	9,66,386	24.2%	867%	***24%***
UltraTechCement	167	598.05	99,874	10.0%	3,905.05	6,52,143	16.3%	553%	***19%***
Unitech	631	158.30	99,887	10.0%	1.30	820	0.0%	-99%	***-36%***
Total			**9,98,236**	**100.0%**		**39,95,950**	**100.0%**	**300%**	***14%***
Nifty 50		**4,360.00**			**11,445.05**			**163%**	***10%***

Prices sourced from ACE Equity; returns do not include dividends.

It is interesting to note that over this period, 4 out of the 10 holdings have given negative returns, with three of them falling by over 90%. Despite nearly 40% of the initial portfolio losing money, the overall portfolio has returned a 14% CAGR until the 27th of March 2019. What makes these returns even more interesting is that all the investments were made in large-cap companies and not in mid- or small- cap names. Returns from a few successful bets have more than covered the losses of some wrong ones (an error of commission). On the contrary, if someone would have missed coming to the market altogether (an error of omission) at that time, that investor would have missed the opportunity to see their capital grow to ~4x its original value.

In our view, the current market conditions may again force this error on to investors. With the sharp correction in mid and small cap stocks over the past one-plus years, investors may be tempted to remain away from this segment, if not the market overall. Therefore, we believe that a reminder that '*the error of omission has larger bearing than the error of commission*' on future returns may be well served at this juncture.

To sum it up, errors are a part of any decision-making process like investing; they are not a flaw but a part of the design of the system. Thus, rather than shying away from making errors, it is important to understand the impact that an error can have on the desired outcome. For investing, in particular, we believe that not investing (an error of omission) can have far more negative consequences than making a few bad investments (an error of commission) in the long run. Given that these errors can only be identified in hindsight, it becomes imperative for investors to identify a process that can help them minimise the errors of commission, so as to further improve their investment performance. On the other hand, if you spend all your time avoiding the errors of commission, you may increase the errors of omission. Thus, as the American psychologist William James said, "The art of being wise is the art of knowing what to overlook."

Until next month…

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