You Cannot Beat the Crowd by Joining It

The last note ended on William Sharpe's arithmetic. Before costs, active investors as a group must earn the market return, because as a group they own the market. Every dollar of outperformance is funded by a dollar of underperformance elsewhere.

That tells you the game is zero-sum. It does not tell you where the winning dollars sit. You get to that by turning the question around.

Invert

Charlie Munger borrowed a habit from the mathematician Jacobi: invert, always invert. Instead of asking how to succeed, ask what would guarantee failure, then avoid it.

So: what would guarantee never beating the market?

Own what everyone else owns.

The consensus is the average. A portfolio that looks like the crowd's earns the crowd's return, less whatever it cost to get there. This is not a statement about odds. There is no version where you hold the average and beat it.

A return different from the average requires holding something different from the average. That is a requirement, not a preference.

The hard half

Inversion only gets you halfway. Being different is easy, and most ways of being different are worse than the consensus. The crowd is right most of the time. That is what makes it the crowd, and why the price is where it is.

Howard Marks has put the rest more precisely than I can: a position has to be non-consensus and it has to be right. Non-consensus and wrong is what funds somebody else's outperformance. Right but already agreed upon pays the average, because the price got there first.

Inversion does not hand you an answer. It rules one out, which is all the tool ever promised. Knowing where not to stand is a smaller thing than knowing where to. It is also the half I am sure of.

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References

Marks, H. (2006). Dare to Be Great. *Oaktree Capital Management memo*.
Sharpe, W. F. (1991). The Arithmetic of Active Management. *Financial Analysts Journal, 47*(1), 7-9.