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Playing to win

"Sir, In their eagerness to impose upon us their plan to force upon society a state of compulsory and near-permanent recreation, Robert and Edward Skidelsky ignore the fact that working to enhance one's ability to consume, rather than settling for what others might deem to be adequate, is a fundamental aspect of personal happiness ("Enough is enough of the age of consumption", July 5); and that it is, in fact, the primary reason that billions of people can choose which of the unparalleled range of today's goods and services best suit them.

"Indeed, personal contentment can undoubtedly be generated by the perception that one is being fairly rewarded for one's efforts. Surely, therefore, the Skidelskys must concede that a major cause of mass unhappiness is the fact that, across most of the western world, the onerous taxes required to sustain our bloated governments ensure many people effectively spend between one third and one half of their time at work serving the state. Watching politicians use the proceeds of one's own work in order shamelessly to buy the votes of particular special interest groups is hardly conducive to good mental health."

- Letter to the editor of the Financial Times from Jack Costello, Co Wicklow, Ireland.

"Sir, Hugh Goodacre's trenchant quandary about the collective "we" (Letters, July 10) recalls a comment made by the late Murray Rothbard in a much older (but oddly familiar) debate.

"In response to the Lernerian assertion that the public debt doesn't matter because "we owe it to ourselves", he observed that it makes "an enormous amount of difference whether . . . one is a member of the 'we' . . . or of the 'ourselves'".

- Another example of the FT's readers being more economically literate than most of its own columnists; this time from David Chaplin, Cape Town, South Africa.

In a recent posting on the continually excellent Farnam Street, 'David and Goliath: the art and science of the underdog', the site's somewhat diffident author reviews 'How the weak win wars' by political scientist Ivan Arreguín-Toft. In an examination of every war fought over the past two centuries "between strong and weak combatants", Goliaths won in 71.5 percent of conflicts. In wars in which one side was at least 10 times more powerful than its opponent (in terms of military resources and population), the weaker side won almost a third of the time.

Farnam Street goes on to summarise the Biblical account of David and Goliath. The King James version has it as follows. The Philistines stood on one side of a mountain by the valley of Elah, and the Israelites stood on another. Goliath of Gath came out of the Philistine camp, "a champion", armed with a coat of mail weighing five thousand shekels of brass and a spear's head weighing six hundred shekels of iron. And he challenged the Israelites to fight. David, youngest son of Jesse, was armed by Saul with a helmet of brass and a coat of mail. But he discarded them, because they had not been "proven". Instead, he picked up five smooth stones from a nearby brook. He decided, in other words, to wage unconventional warfare. He fired off a stone which downed the Philistine. David then used Goliath's own sword to decapitate him.

"What happened," asks Farnam Street, "when the underdogs likewise acknowledged their weakness and chose an unconventional strategy ?"

Arreguín-Toft went back and reanalysed his data.

"In those cases, David's winning percentage went from 28.5 to 63.6. **When underdogs choose not to play by Goliath's rules, they win, Arreguín-Toft concluded, "even when everything we think we know about power says they shouldn't."**

"Arreguín-Toft discovered another interesting point: **over the past two centuries the weaker players have been winning at a higher and higher rate**. For instance, strong actors prevailed in 88 percent of the conflicts from 1800 to 1849, but the rate dropped very close to 50% from 1950 to 1999."

So what explains these results ?

"After reviewing and dismissing a number of possible explanations for these findings, Arreguín-Toft suggests that an analysis of strategic interactions best explains the results. Specifically, **when the strong and weak actors go toe-to-toe, the weak actor loses roughly 80 percent of the time because "there is nothing to mediate or deflect a strong player's power advantage."**

"In contrast, when the weak actors choose to compete on a different strategic basis, they lose less than 40 percent of the time "because the weak refuse to engage where the strong actor has a power advantage." Weak actors have been winning more conflicts over the years because they see and imitate the successful strategies of other actors and have come to the realization that refusing to fight on the strong actor's terms improves their chances of victory.

"But not everyone wants to risk losing unconventionally. The theory goes that if you compete conventionally and lose, tough luck, but if you compete unconventionally and lose, well, you might lose your job. This might be a reason that competition between lopsided opponents is so, well, lopsided. As the famous economist John Maynard Keynes said: "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

Unconventional or asymmetrical warfare is nothing new. Sun Tzu in 'The Art of War' advises that

"If [your enemy] is in superior strength, evade him.. Attack him where he is unprepared, appear where you are not expected.. If equally matched you may engage him; If weaker numerically, be capable of withdrawing; And if in all respects unequal, be capable of eluding him.."

And in perhaps the best film sequel ever made, 'The Godfather, Part II', Michael Corleone, visiting Hyman Roth in Cuba for his birthday, describes something he has just seen in the street that day:

Michael: "A rebel was being arrested by the military police, and rather than be taken alive, he exploded a grenade he had hidden in his jacket. He killed himself and he took a captain of the command with him.. It occurred to me the soldiers are paid to fight; the rebels aren't."

Roth: "What does that tell you ?"

Michael: "They can win."

And in his seminal essay 'Winning the loser's game', Charles Ellis cites Dr. Simon Ramo's book on tennis strategy, 'Extraordinary tennis for the ordinary tennis player'. Dr. Ramo suggests that tennis comprises not one game but two: one played by professionals and a handful of gifted amateurs, and one played by everybody else. Ramo's point:

"Professionals win points; amateurs lose points."

So when amateurs play the sport, they should simply concentrate on getting the ball back over the net with the absolute minimum of flashy moves, and wait for their opponent to make the unforced errors that end up sacrificing the match.

The practice of investing today has much in common with asymmetrical warfare. As has been well said, saving amounts to being the pursuit of the protection of one's purchasing power; investing to being the pursuit of growing one's purchasing power. But when interest rates squat down here at their lowest rates in history, and the "riskless" rates on offer from many supposedly "safe" sovereign bond markets follow suit, even the business of being a saver involves unnaturally high levels of risk, and the business of being an investor even more so. Conventional investment (warfare as usual) offers no solutions.

So play by different rules. The investment world is full of managers operating with artificial but nevertheless iron-clad constraints – a comparison with Goliath would not be wholly out of place. There is no value in conventional western government bond markets, for example – only the illusory comfort of liquidity. Page 9 of last Thursday's Financial Times carried two stories, side by side, pointing to the nature of the challenge. On one side of the page, San Bernardino was being reported as the third city in California to file for bankruptcy. Next to it, the lowest ever yields in history were being reported for a 10 year US Treasury auction.

The surreal opportunity within bond markets today can best be summarised in the observation that the debt of creditor nations in many cases offers higher yields than that issued by the most heavily indebted nations. But only by playing by different rules (and abandoning conventional benchmarks and other self-imposed fund managerial restrictions) can one participate in this alternative fight with a chance of coming out on top.

The previous day, the FT had reported that

"European authorities are pressing Spain to inflict billions of euros of losses on small investors by wiping out certain types of bank debt before its financial institutions are recapitalised using Eurozone rescue funds.

"The bailout conditions for Spain's banks would force any lender taking aid fully to write off their preferred shares and subordinated bonds, according to a draft memorandum of understanding seen by the Financial Times."

To put it another way, no bank debt in the euro zone is safe. (Not that we ever argued it was.) This is a very dangerous game. In the process of making banking bailout policy on the hoof, Euro zone politicians are arbitrarily threatening the savings and investments of millions of people. Why save the legal entity that is a bank – and its management – if you are going to liquidate its bondholders ? And since these rescue funds derive from taxpayers in any event, why throw good money after bad ? Better to nationalise the banks altogether and abandon the farce that these businesses have a future as private entities separate from the state.

Which brings us to the essential nature of the problem. As investors we are not just fighting financial markets – the collective, decision-making, weighing machine of thousands like us. We are primarily fighting governments – the impersonal, arbitrary, monopoly spenders of last resort whose profligacy created the debt crisis in the first place.

And in addition to favouring debt issued by the most creditworthy sovereigns, there is another way of "voting" one's displeasure at the dangerous monetary policy of bankrupt western governments and their central banking agents. It is, of course, gold. So it is doubly convenient that just ahead of the next wave(s) of quantitative easing and currency debauchery, it is available at a discount in price from its recent highs. It would be doubly awkward for the banks, though, if gold turned out to be yet another market they'd been busily manipulating over recent years. Better not go there, and instead simply take advantage of the current attractive price.

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