

# The Power of Probability

## Sometimes the obvious choice is the right decision

by Larry Sarbit, *Advisor's Edge Report*  
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**"If you don't get... elementary probability into your repertoire... you go through a long life like a one-legged man in an ass-kicking contest. You're giving a huge advantage to everybody else."**

- **Charlie Munger,**

*A Lesson on Elementary, Worldly Wisdom as It Relates to Investment Management and Business, The University of Southern California Marshall School of Business, April 14, 1994*

Certainty of the future is of prime concern to investors. But how do investors know if they are stepping onto fertile, safe ground or a field of land mines?

This inquiry is by far the most essential that will help separate a winning approach to wealth creation from what investors fear most—a permanent loss of capital. I have a simple answer, one that will help keep you out of trouble and make you money. The solution may surprise you: it's an elementary understanding and application of the mathematics of probability.

Your initial response may be that you have no interest or understanding of the complex world of probabilistic models. But wait. I have a positive response to your concern: You don't have to! All that's required is to grasp their most basic concepts which I'll try to explain briefly here. Prerequisite: No math required. In fact, if complex math is necessary, we're headed in the wrong direction.

The basics of probability are actually quite elementary. Any event has a probability of occurring somewhere between 0% and 100% as shown in this simple scale below:

0% ←————→ 100%

Many obvious events have simple answers and, fortunately don't require pages of complicated statistical formulas. For instance, what's the probability of the sun rising tomorrow morning? I think we'd all agree it's close to 100%. However, even with something as predictable as this, there is still a tiny element of chance or doubt that it won't occur. So there's probably a 99.9% chance of a positive outcome in this case.

On the other side, if you buy a 649 lottery ticket, what are your chances of winning the jackpot? Another easy response: we all know the chances of winning, while not 0% is as close to that probability as you can get. The beauty of these examples:

you may not have an exact calculated value but having one wouldn't add any useful information, anyway.

Now let's move this concept into the world of finance and specifically, investments. Here are some questions with obvious answers. What's the probability that consumers will be drinking Coca-Cola or Pepsi 3 or five years from now? Will people be shaving their faces and legs with Gillette razors in the future? My best guess is that these are very high probability events.

Can I determine an exact probability of these events occurring? No, but is this required? Again, the response is no. My best guess: there's better than a 90% chance of these events taking place.

Here's a tougher one: what is the probability that the new restaurant that opened down the street being around 5 or 10 years hence? It will be tough to come up with a number if this dining establishment doesn't have a recognizable brand name (McDonald's, Tim Horton's, etc).

Will the high tech firms, who are currently leaders in this rapidly changing field, be in existence in 5 years? The mathematical probabilities could be 60% of success or 30%. But we are sure they are not 90%+. With such probabilities as these, we are in a no man's land where such figures can't give us definitive answers. There are no easy answers to these probability puzzles. The honest answer to these problems is: We don't know.

But there's good news in this admission. When the probabilities of success are obviously not high (90% or better), this is a powerful bit of knowledge in the world of finance and investing. What we do know is that if there is not a high degree of certainty in the outcome, the risk of loss has likely increased dramatically.

One more example: what's the probability that the unwashed masses will need professional advice in planning their financial future? Do you think the nature of the basis of your business—establishing relationships and trust with clients—will change much over time? My answer: the nature of your business won't change. What are the odds that you will be doing this same thing three or five years from now—working with people who need financial help? Products will change, guaranteed. Markets will change invariably. But that personal, caring relationship

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you have won't alter—a 90%+ probability event. The nature of the business of helping people on a one-to-one basis won't vary as it has not over the past 100 years. No technological change will likely come between you and your clients. This should give you a great deal of comfort that you are in the right business—you have certainty and high probability. Congratulations on a great career selection.

I'm looking for the same thing you have in your practice—high probability events—"No Brainers", as Warren Buffett describes them. Likewise, when I look forward three years, I know the businesses I am investing in will be doing more or less the same thing they are today. And they will be producing more free cash flow and be worth more than they are today. I select only those companies with these obviously positive outcomes. The odds of mistakes and loss of capital have been reduced to as close to a zero probability as is reasonable to expect.

Stick to high probability events that are obvious and your chances of loss are low and investment growth is high.

Welcome to a simple but effective recipe for investment success.