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The Most Important Thing

Published on: 14 February, 2020 | Author: Investment Team

A good idea taken to its logical extreme is often how bad ideas are conceived. There are many examples of this in fields as diverse as biology and finance. For investors, this is very important because one of the biggest threats to generating good returns is engaging in irrational competition.

Why did the Irish elk become extinct? Largely because of irrational competition. The Irish elk had very large antlers. These were useful for fighting off predators. More importantly, they were useful for fighting off other rival elks when competing for mates. Large antlers became a signal of supposed strength and health. Natural selection took its course and over time, the antlers grew larger and larger. At a certain size, the law of diminishing returns took hold i.e. the elk had no extra benefit in having larger antlers to fight off predators – they had won the war.

However, competing against other elks for mates based on antler size meant that the elks, in aggregate, couldn't survive simply by having bigger antlers. This was an example of irrational and unsustainable competition. The Irish elk finally went extinct when the antlers grew to such a size that the animal could no longer hold up its head and increasingly got entangled in trees.

Because of complex competitive dynamics, the very factor that aided the Irish elk in fighting off predators i.e. its large antlers, was eventually its Achilles heel.

A similar analogy can be drawn with finance/investing. Right now, the view of most investors is that the road to riches lies in betting on electric cars and battery technology replacing traditional internal combustion engines. This replacement is likely to happen and will improve the climate and the respiratory health of people living in big cities. However, this doesn't mean that investors, in aggregate, will make any money betting on this change. Why? Because of irrational and unsustainable competition.

Warren Buffett gives a great example of how correctly predicting the growth of a new sector in the economy does not necessarily correlate with more riches for investors. In the early 1900s, it would have been obvious to most that the automobile will replace the horse. An astute investor, not thinking about the complex competitive dynamics of such a change, would have invested in automobiles since they were "the future".

However, a lot of people wanted a piece of this future. In the US, there were about 2000 automobile companies that failed because of rabid competition and technological change. Out of these 2000 car manufacturers, Chrysler, Ford and General Motors were successful – a success rate of 0.15%. Even out of these three, only Ford has never filed for bankruptcy.

In Britain, the only major car manufacturer that hasn't, at any point, declared bankruptcy is McLaren. Over 400 other manufacturers have died out.

Who was the loser during the transition from horses to the internal combustion engine? Horses and most investors betting on the automobile. The winner was the customer who got a variety of cars to choose from at competitive prices.

What is clear is that any specie, like the elk; or industry, like automobile manufacturers, engaging in irrational competition will have a lot of casualties. And investing is just as much about avoiding casualties as it is about picking winners.

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