

# Investing and Basketball: What You Can Learn from the World's Greatest Coach

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When times get rough, emotions run high. Babe Ruth goes into a slump. Tom Brady gets intercepted...twice in one game! Bill Russel goes 1-12 in foul shots. Even the best have bad games. Some have bad seasons. There could be a lingering injury, maybe the ball was tipped, maybe the team needs some rebuilding, or perhaps circumstances just turned out that way. Not everything is under our control. Great coaches recognize this, and have patience and faith in their players. Red Auerbach, the hall of fame coach who spent the majority of his career with the Celtics, worked with and indeed built some of the best teams and players in all of basketball. And he did it for decades. Did the Celtics have bad games and bad years amongst all those championships? Of course. Did Red fire or trade his best players after a few bad games? Of course not!

Now let's explore how you manage your investment manager(s) through the lens of Red Auerbach. What kind of coach are you? Do you focus on past successes at hire and then fire the manager at the first bad month or quarter? Do you focus on ability (process) or record with the previous team (performance)? Do you give a fair period to evaluate both the process and performance? Like a pro athlete, every investment manager will go through periods of underperformance. Perhaps the asset class they specialize in is struggling as a whole, their management style is temporarily out of vogue (value versus growth, etc.), or there might really be a problem such as a change in portfolio managers or process. Like coaching a great basketball team, the art of managing investment managers often requires patience in the absence of something materially wrong. It also lies in setting proper expectations up front.

## When hiring a manager, we would recommend asking a few pointed questions:

- Please explain your investment philosophy and process.
  - *Ask yourself: Does this make sense to you? Do you agree?*
- What would be your expected drawdown if the markets fell 51% like the S&P 500 Index® did in 2007-2009? Be sure to check their historical drawdown.
  - *Ask yourself: Can I handle this magnitude of drawdown?*
- What would you expect your volatility to be versus your preferred benchmark? Then check their Beta and standard deviation)
  - *Ask yourself: Can I handle this level of volatility?*
- Are you free to make both the buy and the sell decisions? To explain further, if your area of management expertise enters a period of failure, can you shift assets to cash or other asset classes or will you stay fully invested even in the worst market environments?
  - *Ask yourself: Am I comfortable with a manager that will stay invested in a 2008 type market?*
- What kind of upside and downside capture should we expect over time?
  - *Ask yourself: Does this meet my expectations?*
- How much time? Do they measure in years, a full market cycle, or some other period?

Managerial process and fit into your process are the keys. Open communication also plays a major role. If the performance does not meet your expectations, find out why. Was there a process or managerial switch or glitch? Was there some other material issue or was it just a bad month/quarter? If there was a material change, such as a new portfolio manager, then replacing may be in order, especially if the new manager is light on experience.

Irrational emotions and expectations have no place in the management of a team or investments. Chasing "hot" performance has proven to be folly time and time again. Building diversified portfolios that can withstand just about any market environment is akin to Red building his Celtics teams. They played offense and defense. They picked each other up during the dry spells and thrived as a team over the long term.

Many firms come out with annual rankings of funds, ETFs and managers. Did you ever notice that last year's best performer rarely makes it into the top quartile the following year? So what is a valid period to review a manager's performance? We'd argue three years, but we'd even settle for two. Why? Because one missed foul shot or even a bad call can ruin a game or put an end to a season. Would you have fired Larry Bird for this? When the bad month or quarter inevitably happens, what do you do? Call and confirm that there have been no personnel, structural or process changes. If those changes have occurred, consider a search process as appropriate.

If there are none, consider this: in NBA basketball, there are 82 regular season games between October and April. This means each team plays two to three times per week, constantly facing new opponents, attempting new plays, balancing playing time, and managing injuries and other setbacks. If every time a team lost, the coach fired his players or threw in the towel, they'd never make it to the playoffs, let alone through the first month of games. A great coach knows that building a championship team takes time, perseverance, and prepares all those involved for the bumps along the way.

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