

Bets and the Stock Market

October 2024

Dear investors,

We have been following the betting phenomenon in Brazil, where online betting sites have become a craze and reached surprising proportions. In August of this year, according to a survey by the Brazilian Central Bank (BACEN), BRL 21 billion was spent on bets. Of this amount, BRL 3 billion was spent by Bolsa Família recipients, triggering a wave of criticism of the activity, which causes financial harm to a segment of the population that is already financially vulnerable.

Following the maxim that history does not repeat itself but rhymes, this is just another version of an old and well-known human problem. Many nations have faced periods when gambling became fashionable and caused deep problems. Behind every such story lies something difficult to change: the human propensity toward gambling addiction. It is not a simple psychological phenomenon. Although the rational solution is obvious — simply do not gamble — it is difficult to find a practical way to prevent people from doing so.

The impulses that drive betting are also well known in the world of investing. There are people who clearly see the harm of betting but at the same time act recklessly in the stock market — like a poker player who condemns the dice player's habit without noticing that their own addiction is very similar.

To avoid becoming yet another victim, one can seek to understand the psychology behind gambling addiction and conduct an honest self-analysis in search of potentially harmful behaviors within oneself. Identifying a problem is the first step toward solving it. That will be our subject.

Historical Overview

In ancient Rome, betting on dice games, gladiatorial fights, chariot races, dart throwing, and other sports was a very popular practice. There is evidence of numerous attempts at legal control, through sanctions against gambling establishment owners, fines imposed on participants, and outright prohibition for military personnel and government officials.

During China's Ming and Qing dynasties (14th to 20th centuries), gambling was extremely common. Lotteries, card games, dice games, mahjong, and betting on races and animal fights all flourished. The Ming government went so far as to impose an outright ban on gambling, with severe penalties: fines, imprisonment, and physical punishment for gamblers and operators of gambling establishments. Even so, the activity remained popular for centuries.

In 16th-to-19th-century England, lotteries, card games, and horse race betting became common among both the aristocracy and the general population. In 1845, a new law called the Gambling Act attempted to suppress these activities. Gaming houses were banned, protections were created for vulnerable individuals such as minors, and debts arising from gambling became unenforceable through the English judicial system. The law had some positive results, but also some side effects. For example, since gambling debts could no longer be legally collected, alternative collection methods became more frequent.

These historical examples make two points quite clear. The first is that gambling is harmful to society, as it leads many individuals to financial ruin, destabilizes families, and encourages criminal activities. It is no coincidence that governments across different eras and cultures have tried to suppress the practice among

their populations. The second point is that attempts at regulatory suppression have not been effective even when imposing harsh penalties. The problem is chronic, much like drug use.

With this historical context, it is difficult to imagine that Brazil will easily escape the harmful consequences of betting. It seems to us that something like this could only be mitigated through the Confucian concept that, to bring order to the world, you must start by cultivating virtue within yourself, then bring order to your family life, then contribute to your community, and so on, expanding order to ever broader circles. It is a long road and one that is unlikely to receive meaningful attention from the government.

Despite the pessimistic prognosis, publishing this text is the contribution within our reach.

The Psychology Behind Gambling

The first step is to understand where the propensity toward gambling addiction comes from. A series of psychological factors interact to create this bond with betting schemes. The beginning is usually unpretentious, motivated by curiosity and the pursuit of fun — by the adrenaline of placing a bet and rooting for the desired outcome, and by the pleasure of imagining what could be done with the prize money. When the betting begins, the traps emerge.

One of them is that the human mind tends to look for patterns in historical events, without bothering to verify whether they are statistically significant or merely random accidents that create the appearance of order — similar to the possibility of seeing a cloud shaped like an elephant. This leads gamblers to theorize about methods of predicting outcomes and to create an illusion of control over what remains purely random. Sometimes this behavior is clearly superstitious, like the person who shows up to World Cup games wearing a strange shirt and claims Brazil always wins when they watch wearing it. In more dangerous cases, a kind of pseudoscience develops, with elaborate methods, strategies, and “technical analyses” that give the appearance of something serious but are based on false premises and consequently do not work. In financial markets, methods of *day trading* are a clear example of this last case.

Another perverse bias is selective memory operating on past guesses, including situations where no bet was actually placed. People remember their successes far better than their failures and thus create an illusion of skill based on this preponderance of positive memories. In betting, it is the memory of correctly predicting three football match results in a row. In the stock market, it is the case of someone who casually thinks about investing in a stock but does not act on it. Months later, they see that the stock rose sharply and conclude that all they lacked was the courage to act on their “knowledge” to earn a huge return. They feel foolish for not having trusted their own ability and plan to invest the next time they “spot an opportunity.”

There are also the near-misses. In betting, it is the match that ended 3-1 instead of the 2-1 you bet on. In the stock market, it is the stock held for so long and sold just one month before it rose 20%. In hindsight, everything seems more obvious, and the impression arises that the method being used is on the right track and just needs a few refinements to work well.

The experience of winning multiple times also motivates continued play. Even with the negative average return that is common to both gambling and speculative investing, that average is composed of several winning events amid the many losses. Looking back and analyzing the results obtained so far should make the picture clear, but it is difficult to act with detachment. When winning, the urge is to keep going to win more. When losing, the urge is to keep going to recover what was lost before stopping. The impulse to keep playing never ends.

Even the success stories that inspire newcomers are like the mythical sirens’ song that lured sailors to their deaths at sea. The stories of people who quickly grew wealthy with little effort by investing in stocks are real, just as is the case of the poker player who walked away with a *royal straight flush*. Both are possible events, but extremely rare. Since winners tell their stories far more often than losers do, far more success

stories than failure stories are heard, and the impression is created that the odds of success are higher than they actually are.

Each person's propensity to fall into these traps depends on their personality, core values, and life situation. Those who already have a propensity toward gambling addiction, care little about self-discipline, and find themselves in a vulnerable situation have a high chance of being seduced by the possibility of quick gains through betting. Once started, many find it difficult to stop.

Investors vs. Gamblers

Stock exchanges and gambling houses are very different environments, but some behaviors manifest in both places. In the stock market, there are two very distinct investor profiles. One is the person who analyzes each opportunity in depth and makes decisions in a rational, well-founded way. The other is the person who buys stocks based on instincts or hunches, without much pretense of understanding the business they are buying. For the first profile, investing is not a game of chance. For the second, it is a game perhaps even worse than a casino. In a roulette game, the odds of winning are about 5% lower than the odds of losing. In the stock market, the uninformed trade against numerous professional, competent, and diligent investors.

This representation shows the two extremes, but there is a broad spectrum of possibilities between the perfectly diligent investor and the entirely irresponsible one. Few people see their own behavior as that of a speculator, and it is relatively common to see people acting in risky ways without full awareness of the risk. A few simple checks can help identify potential problems.

The fundamental question one wants to answer when evaluating a stock is whether its price is above or below the fair value of the business. As a result, it is necessary to estimate what that fair value is. This task involves a series of uncertainties and even experienced investors can make valuation errors, but all of them know the discounted cash flow method, which is the fundamental mathematics behind the pricing of financial assets in general. Those who rely solely on the stock's price history and the simplified logic of *valuation* multiples will be at a clear disadvantage in the market.

It is also essential to maintain an accurate record of all investments made, including transaction costs, and to calculate the consolidated portfolio return — ideally over long periods. This is the only way to assess the success or failure of investments. Although obvious, it is quite common to see independent investors who evaluate their holdings on a case-by-case basis without consolidating their returns. They hold good memories of gains and seek to forget losses, never knowing whether the time they spend on investments is profitable work or expensive entertainment.

Anyone who frequently finds themselves holding a stock only until it returns to the price they paid — to recover the loss — or selling stocks after a small gain to lock in profits should reflect on whether they are truly acting in a rational and well-founded way. Holding what is falling and selling what is rising is a classic cognitive bias, quite similar to the behavior of gamblers, who take more risks to try to recover losses than in pursuit of additional gains.

A final recommendation is pure and simple intellectual honesty in answering the question of whether one's own investments are being made responsibly or whether they are based on hunches and instincts. There is a myth that great investors are those who have sharp instincts and act on impulse at the right moments, capturing large gains over short periods. The reality is far less exciting than that. Instincts hinder more than they help, and a large amount of analytical work is involved in every decision.

Even investing responsibly offers no guarantee of success, since the stock market is a competitive environment. It is not enough to be right — you need to be more right than the average of the other participants to achieve a superior return. The importance of being diligent and technically well-grounded

stems from the fact that the alternative style — investing with the attitude of a gambler — will very likely guarantee failure.

The Consequences of Gambling in the Stock Market

Bringing the spirit of gambling into stock market investing produces the same harms. Irresponsible investing can also lead to financial ruin and the destabilization of families. One does not hear much about this because the tragic cases are not very representative compared to the total volume of capital traded in the market, and because the stock market has a genuine economic function — allowing companies to access capital and providing liquidity to investors. Furthermore, the minimum investment in stocks is far higher than on betting sites. While betting apps allow wagers from BRL 1, a standard lot of Petrobras shares costs around BRL 3,600 today. In other words, losing money in the stock market is a problem for the middle and upper classes, who are less easily labeled as victims in news coverage. But one only needs to have an honest conversation with an investment advisor to see that such cases are relatively common.

There is also a parallel between operators of gambling establishments, who take advantage of those prone to gaming addiction, and certain agents in the financial market who display the same predatory behavior of exploiting uninformed people. The mechanisms of exploitation range from the obvious pyramid schemes — which, despite being illegal and well-known, always manage to attract a number of unwary individuals with promises of high, guaranteed returns — to more sophisticated and perfectly legal cases of investment products created by financial institutions and sold to their clients without full transparency about the risks. The client usually even signs a document stating they are aware of all the product's characteristics, which shields the financial institutions from potential liability, but almost no one reads the long and tedious contracts. Only the most extreme cases appear in the media occasionally, and are quickly forgotten. The warning we leave is that each person must take full responsibility for protecting their own wealth.

For the country, treating the equity market like a giant casino is also not beneficial. Investors interact with the real economy through two main channels. The first is through primary offerings (*IPOs* and *follow-ons*), processes that provide new capital to companies. Investing in these offerings without proper analysis results in poor capital allocation and the consequent waste of the country's existing resources on low-return economic activities. The second is through the influence that investors exert over the executives of listed companies, who seek to please the market in the hope of contributing to a rise in their share prices. In both cases, the direct responsibility lies far less with individual investors than with professional managers who move large volumes of capital. However, managers respond to the desires of their clients. If clients demand quick returns, strategies become short-term-oriented and far more subject to the vagaries of chance.

While this type of behavior becomes increasingly common in the market, we have the privilege of working with highly discerning clients who maintain a long-term focus and a strong philosophical alignment with our fundamentalist approach. This allows us to execute a far more rational and considered management style, which has been generating excellent returns for our investors for more than a decade.