How investing is – *and isn't* – like a game of Texas Hold 'Em *(page 1 of 3)*

The strategic and tactical similarities between investing and poker have long been a source of fascination and study on Wall Street. A disproportionate percentage of brokers are avid amateur poker players – some have turned pro. Several firms say they actually look for card-playing skills when hiring brokers, according to a recent story in Money Magazine. Others use basic poker principles to train their traders.

None other than Peter Lynch, the legendary head of Fidelity's Magellan Fund in the 1980's, said stock investing was "most like" playing poker.

And then again – not. The differences are as striking and instructive as the similarities.

The most obvious difference is that investing is not a zero-sum game. In poker, your winnings exactly match somebody else's loses. But in investing, if stocks have superior returns over time, theoretically everybody can win.

Some more than others, of course. And that's where poker comes in.

Offhand, it might seem that a game of cards – i.e., gambling – is the worst possible venue from which to draw lessons for level-headed investing. But in terms of the active vs. passive portfolio-management debate, the parallels are uncanny. Most of us have played a few pick-up games of stud or Omaha, and we've learned enough to know that we won't be quitting our day jobs anytime soon. But the fact is, an elite cadre of players makes a good living at this unlikely endeavor, year in and year out.

Doyle Brunson, for example, has won 10 world championship bracelets. Somehow he and other professionals have "factored in" the element of chance – not entirely, of course, but to an extent where they can financially plan, build careers, purchase homes, raise families … and even write books on how it's done.

What are their secrets? And what can we learn from them?

For this essay, we talked with a man – an investor – who refers to poker as his "hobby" (though some would describe him as semi-pro.) "Pete" is not unlike you: well-educated, with a family, home and a thriving (non-poker) career. He's a Ph.D. consultant who specializes in marketing group-medical practices.

Pete travels the country holding seminars and consulting with physicians. This schedule enables him, between engagements, to "dabble" in poker – exclusively No Limit Texas Hold 'Em, at a consistently high level – at a casino near his home in Kansas City, two or three afternoons a week, never for more than a few hours per session.

For four years now, Pete has earned $20k to $30k annually at poker. That's net, not hype. (We've checked.) You'd never know it to look at him. He is soft-spoken. Drives a Volvo. And never misses his son's basketball games.

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Over this time, he's adapted a number of his own "rules of the road" which provide an enlightening view of poker … and his investment strategy.

Rule No. 1:

Winning consistently at poker isn't about taking risks. It's about systematically minimizing risks.

As you may know, No Limit Texas Hold 'Em is something of a national craze right now. It's on ESPN and other channels regularly (thanks to a camera that allows you to see a player's hole cards). NOTE: Casinos and off-shore internet-gaming comprise a spectacular growth industry that has been the subject of much moralizing and analysis. But gaming as a sector is another story. Here we're discussing "gaming theory" – and how it pertains to you.

Briefly, here's how No Limit Hold 'Em works. As the professionals say, it takes a few minutes to learn … and a lifetime to master.

Two "hole" cards are dealt face-down to each player. These two cards are yours exclusively.

Then a succession of five "community cards" are dealt face-up in the center of the table – three at once (called the "flop"), then a fourth card, and finally a "river" card – which players use with their two "hole" cards to make their best 5-card poker hand.

These cards are "your market" for any given hand, Pete says.

Betting ensues. Players fold, raise, call, re-raise … and occasionally go "all-in" (betting all their chips) … all the while attempting to "read" the situation, and each other, for information or "tells." Action at the table would seem the farthest thing from steady, principled investing.

Except for the decision-making process.

"Anybody can play aggressively – and at times, in poker, you have to," he said. "But if that's your core strategy, you'll be at Losers Anonymous by the weekend."

"This game is about taking what you know and quantifying the probabilities, correctly figuring the number of potential 'outs' you've got … and the outs your opponent has … systematically minimizing the risk.

"It's about not taking the huge gamble if you can avoid it."

"When players make mistakes, they're usually counting errors, math errors," he said. "But still … you can run the numbers perfectly and get a bad beat every once in a while. That's poker."

In other words: the overriding element in common between stock markets and poker is that in both scenarios "players" must operate with incomplete information.

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"Nobody can know what the "river" card will be ... and you can't know what a stock price will be tomorrow. But in the long run, if you correctly figure all of the probabilities, you'll always bias the outcome in your favor," Pete said.

We've been waiting for this moment in the essay to make a revelation that shouldn't surprise you – it turns out that Pete is an index investor, not a stock picker. His reasoning is eminently logical:

Rule No. 2:

Intuition ... big bets ... timing ... are overrated. Over time, you win by consistently making good decisions.

"The really good players talk about making great 'lay-downs' as much as pulling an Ace on the 'river,'" said Pete. "It takes guts to play poker. But to win, it takes a bit of well-managed cowardice too."

The name of the game is consistency, making good decisions, correctly analyzing all the available information, calculating the pot odds and making only "value bets" ...that's the only way to factor in the occasional bad beats.

(Sort of like building a diverse, properly-allocated index.)

This is much easier said than done. The challenge – the slippery slope for poker players – is one that investors know well: emotion. In poker parlance, a player who's "chasing the last hand," forcing bets, just reacting, is said to be "on tilt."

(So in both a literal and figurative sense, an unbalanced investment portfolio also is "on tilt.")

Pete is keenly aware of the seductive market-timing temptations of poker. And scrutinizing other players for "tells" is vastly overrated, he says.

"The only thing more pointless is trying to find 'tells' in the stock market, which is what brokers are doing nonstop ... 24/7. That's not for me. Way, way too many unknowable variables. You're better off playing poker than picking stocks."

Well said.

Here are few more of Pete's rules of the road. They make a good map for any poker enthusiast ... or investor.

Never act on emotion.

When you think long, (usually) you think wrong.

Never chase a bad hand. Let it go.

There's no such thing as a sure System for winning, only for losing. (For example, always playing aggressively.)

Know your limits. (end)