3 Investment Lessons from the NBA Finals

Jonathan Scheid, CFA, AIF®, Vice President, Portfolio Strategy & Education, Loring Ward

Another National Basketball Association (NBA) season is in the books and it concluded with the same two teams meeting up in The Finals as the prior three years. The Golden State Warriors defeated the Cleveland Cavaliers again, so the Warriors have beat the Cavaliers three out of the last four years. The Warriors put together their winning ways by using a number of strategies that work well in the investment world as well. Let's look at how the Warriors did it and how our portfolios follow a similar strategy to help investors reach their goals.

Concentration versus Diversification

The NBA Finals were typically positioned one way this year: The greatest player (i.e., LeBron James) versus the greatest team (i.e., Golden State Warriors). LeBron James is an incredible player, some argue the best there is, and Mr. James has proven this by taking the team he is on to The NBA Finals the last eight seasons. While he surely has a cast of other talented players around him to get results, he is typically the main playmaker. If he is having a great night, his team usually will win. But if he isn't, the results are not as good. This year's Cavaliers team was very dependent on Mr. James as the talent was very concentrated.

On the other hand, the Golden State Warriors were a diversified team. They had multiple playmakers capable of stepping up and scoring if someone was having an off night. They also had a deep, experienced bench so they could rest their playmakers throughout the season and during the playoffs.

As in basketball, concentration is seen quite often in investing. It could be an investor buying and holding just few stocks that they like, an investor buying what they think is a hot sector mutual fund or asset class, or even an investor buying multiple mutual funds that actually invest in the same stocks. The challenge with the concentration approach is that it relies exclusively on how those handful of companies or sectors perform. For example, if all we invested in were technology stocks, our results would be dictated by how well technology stocks perform. It may make our portfolio look like a hero or a zero.

When we build portfolios, we use diversification. Like the Warriors, we diversify our portfolios among a variety of star players that we call factors of return like value and small cap, both in the U.S. and abroad. When we have multiple sources of return in our portfolio, we don't need all of them to be the best to get the results we need. Value stocks might do well one year and then small stocks may do well the following year. Diversification helps smooth out the investment path we take toward our goals.

Given our preference for diversification, we don't find it surprising that a diversified team beat a concentrated team three out of the last four championships.

Defense Wins Championships (and Preserves Wealth)

My son and I like to joke about the post-game interview where a microphone is quickly put in front of one of the winning team's players. The interviewer usually asks, "How did you win the game?" This is when my son and I shout at the TV, "We scored more points than the other team!"

While scoring more points than the other team is obviously how you win the game, it only tells one side of the story. Defense is vital in basketball. A blocked shot, a stolen pass, or keeping the ball out of the hands of a star player all can limit the number of points that the other team scores and can give your team an advantage.

In the investment world, our defense comes from dissimilar price movements. When we pair risky stocks with conservative bonds, we do so in an effort to control portfolio volatility. If we only invested in stocks, we'd have to tolerate the large swings of the stock market. For some that is a risk they are willing to take, but to others, it makes for many sleepless nights. Bonds typically move in the opposite direction of stocks when stocks decline, so they serve as a great defense against volatility. Defending our portfolio against large declines lowers volatility, and lower volatility helps preserve wealth.

A quick comparison should help illustrate the point. When a portfolio declines 20%, it takes a 25% return to get back to even. When a portfolio declines only 10%, it takes a 11% return to get back to even. The larger the decline, the harder our assets have to work to get back to even. By reducing volatility, we can let our investments work harder on growing.

Have a Plan, Work the Plan

When the Warriors struggled during the season and playoffs, it was when they didn't follow their plan. Please forgive the basketball jargon for a moment, but when Stephen Curry was out with an injury for the last part of the regular season and early part of the playoffs, the Warriors relied more on isolation basketball. Isolation basketball is when a team gives the ball to a star player and the rest of the offense moves away from that player to give them space so that player can try and score. Isolation basketball turns a team sport into one-on-one basketball. Many teams rely on isolation basketball, but a growing number of teams are changing to a different style…a style perfected by the Warriors.

The Warriors play what is referred to as stretch offense. They like to spread the defense out when they are on offense and then move the ball very quickly and multiple times before a player will take a shot. It’s possible that they will pass the ball eight to 10 times before someone is open and will take a shot (which is usually a three-pointer). Stretch basketball is their plan and, when they work their plan, the results are impressive.

For investors, a financial plan is our plan. A good financial plan covers everything from goals and objectives to implementation. It will outline how much an investor should save for their various goals and how they should invest their assets. While it may be hard to stay the course when markets are volatile or some new luxury item catches our eye, following the plan typically gives us the highest chance of achieving our goals.

The Investment Dynasty

There is a lot of debate about whether it is time to call the Golden State Warriors a dynasty or if they still have something to prove. With most of their core players in their prime playing years, it seems likely that the team is, and likely will be, the dynasty organization other teams will have to deal with for some time. For investors, the points we lay out above are all part of an investment dynasty that has stood the test of time. Many of the theories that support the above views have won Nobel Prizes (the investment world’s Larry O-Brien NBA Championship Trophy) or helped investors achieve their goals. Fortunately for investors, this investment dynasty seems capable of lasting a very long time and is one we can all use.

Diversification is not a guarantee against loss. ***Past performance is no guarantee of future results.***