



# WHY SIMPLICITY WINS?

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# SUMMARY

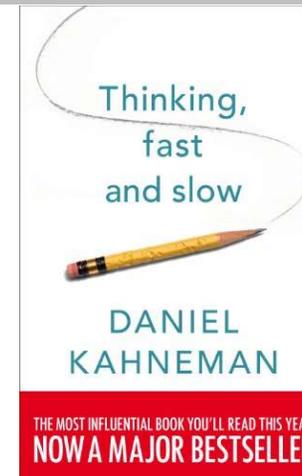
Private & Confidential.

- **The human mind is inherently flawed. While we like to think we are smart, our decisions are based on miscalculated probabilities.**
- **We love telling ourselves stories to suit our bias. This delusional thinking spreads into our investment decisions as well.**
- **How do we escape this trap? Keep things simple. There are enough examples in business and in investing that prove that simplicity works.**
- **How to implement simplicity in investing?**
  - **1. Develop original thinking**
  - **2. Use less judgment and more rules**
  - **3. Develop your own quantitative framework**
  - **4. Ask the right questions**
  - **5. Test uncharted territories**
  - **6. Make time your friend**

# THE HUMAN MIND IS INHERENTLY FLAWED

- Humans are inherently flawed creatures prone to making reflex decisions and miscalculating probabilities around risk-reward trade-offs.
- Behavioral sciences have shown a list of biases that plague the human mind. Daniel Kahneman and Amos Tversky have demolished the idea of a rational mind.
- Kahneman and Tversky have shown “systemic errors in the thinking of normal people” traced to “errors to the design of the machinery of cognition”.
- Our brain simplifies shortcuts of intuitive thinking; biases are manifestations of these shortcuts (or heuristics).
- These shortcuts include representativeness, availability, and anchoring – all used while making decisions under uncertainty.
- “Humans constantly fool ourselves by constructing flimsy accounts of the past and believing they are true” – Kahneman quoting Taleb.
- WYSIATI rule – What You See Is All There Is!

## Thinking, fast and slow



Source: Amazon.com

## How we see ourselves relative to others

### Johari Window

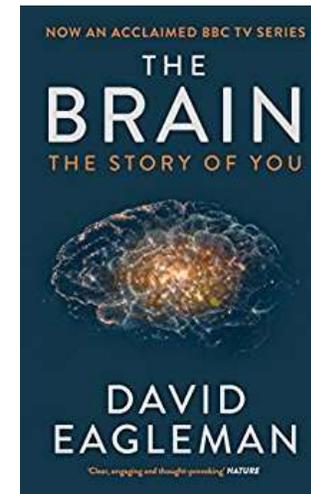
|                     | Known to self | Not known to self |
|---------------------|---------------|-------------------|
| Known to others     | Arena         | Blind Spot        |
| Not Known to Others | Façade        | Unknown           |

Source: Wikipedia

# THE WAY OUR BRAINS ARE WIRED CREATES ISSUES

- Early theories of rational minds are being challenged by science. The brain is composed of multiple, competing networks, each of which has its own goals and desires.
- “Your brain is like a neural parliament, composed of rival political parties which fight it out to steer the ship of state.” [Eagleman: The Brain - The story of you]
- We hunt for simple solutions to complex problems, searching for abridged summaries like “I am safe here” to guide us quickly.
- “The very idea that our minds contain ‘hidden depths’ is utterly wrong.” [Chater- The mind is flat]
- “The stories we tell to justify and explain our own and others’ behaviour aren’t just wrong in detail – they are a thorough fabrication from start to finish.” [Chater]
- Once stories are firm in our mind, we strongly resist changing them. “Spend less time trying to convince individuals of a new perspective, and more time trying to understand and thereby to neutralize the resistances” [Howard Gardner, Changing Minds]

As we learn more about our brains....



Source: Amazon.com

...we question previously held beliefs



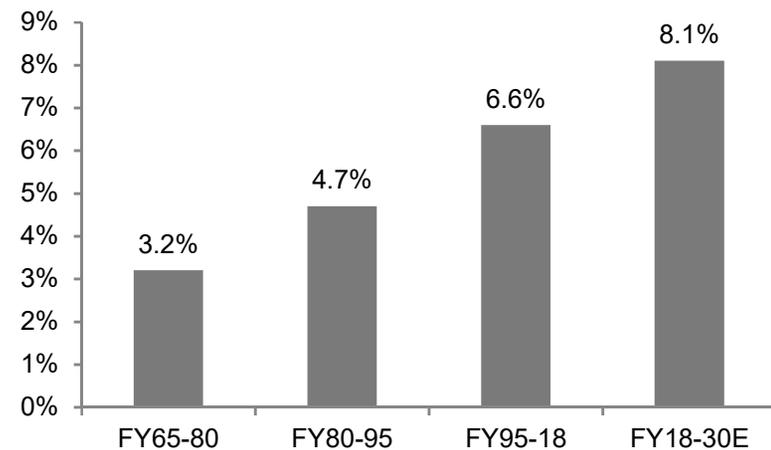
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Source: Amazon.com

# MAJOR ISSUE: DELUSIONAL THINKING

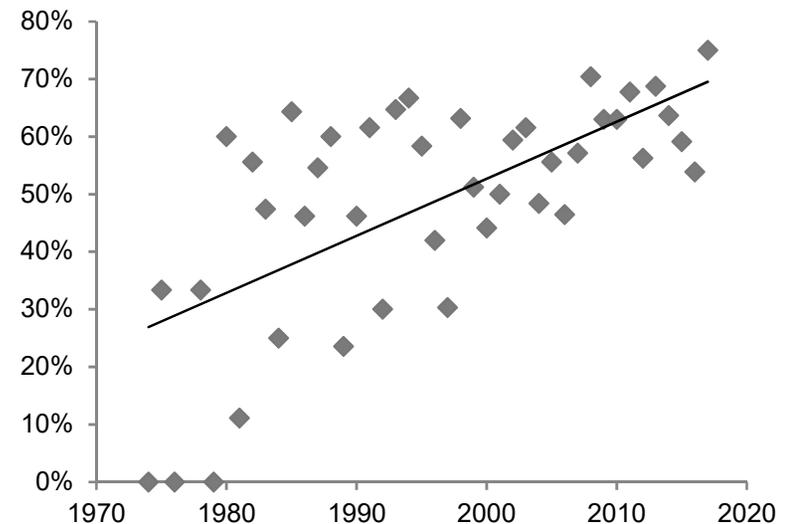
- The human mind struggles to look beyond the here and now and focus on the long-term structural trend. We have an emotional need to cast what we are seeing in a human narrative of individual greatness/failure.
- Myth: “Great men” (eg: Nehru, Indira Gandhi, Narendra Modi) have single-handedly driven India’s economic growth.
- Fact: the driver of India’s steadily improving economic growth rate is a competitive political system which incentivizes politicians to provide an incrementally better deal to the voters.
- Myth: Indian cricket performance depends on the success/failure of individual players and, especially, the captain.
- Fact: We have become better as our coaching facilities have improved, the fitness regime and the diet of our players have improved, as more technology has been used in training, selection and tactics, as the financial package of the players has improved, etc.

## India’s GDP growth – secular uptrend



Source: MOSPI, RBI, Ambit Capital research

## India’s ODI win loss ratio over time has improved

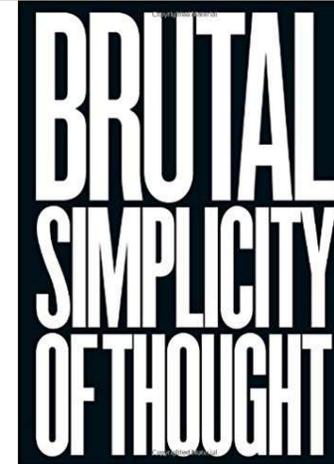


Source: Cricinfo, Ambit Capital research

# SOLUTION: KEEP THINGS SIMPLE

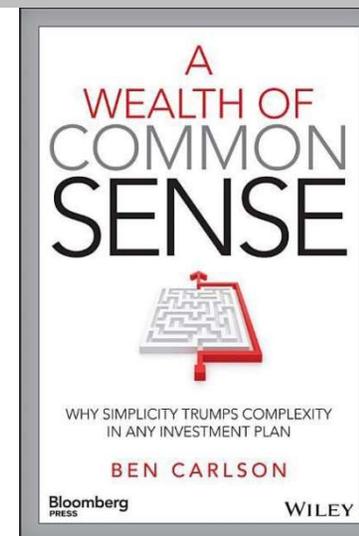
- Simple strategies are easy to understand, easy to implement, easy to sell to others, and easy to course correct from.
- Given that our flawed brains mistake noise for signal, simple strategies are easier to understand.
- But, what is simple is not necessarily 'easy'. In fact what looks simple is often the result of many complex, powerful things interplaying with each other.
- Simplicity has deep spiritual foundations which allows you to anchor yourself and your simple strategies in something far more powerful than your conscious mind.
- There are many success stories of how simple ideas became powerful products in business – from Apple to Amazon to HDFC Bank's retail-led, systems-driven banking approach.
- Similarly, in investing, a simple approach works - from using ETFs to using rule-based frameworks that do not require too much human intervention. Simple, rules-led portfolios have demonstrably beaten benchmarks.

## Simplicity works in business...



Source: Amazon.com [Author: Lord Saatchi]

## ...and in investing

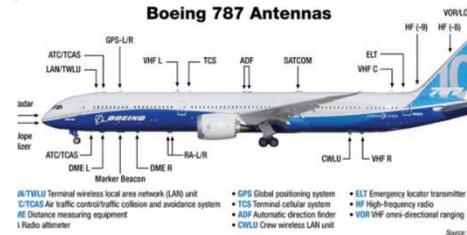


Source: Amazon.com

# WHY SIMPLE ISN'T EASY

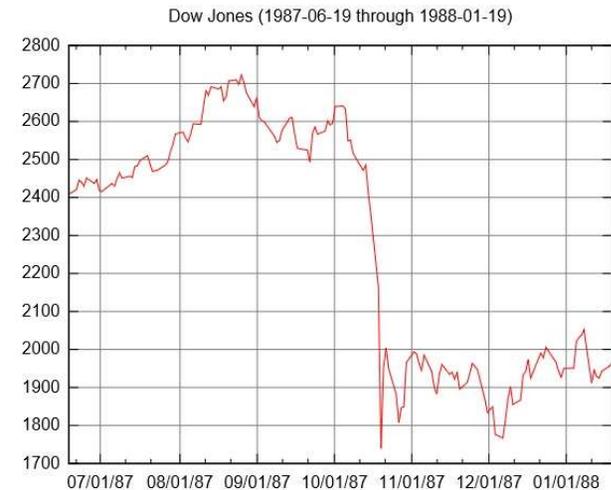
- The world is a complex place. Our understanding of even simple concepts is still evolving. For example, science tells us that time is NOT uniform, it flows at different speeds depending on where you are and how you move.
- What appears simple is actually the result of painstaking effort. “It took me a whole lifetime to learn how to draw like a child” – Picasso.
- Simplicity can also challenge widely-held beliefs. While we may think we know a lot, in fact, we have a knowledge illusion. Humans think in groups and not as rational individuals.
- Black Monday (Dow fell 23% on 15<sup>th</sup> Oct 1987) was triggered by just three words – “not particularly pleased” from Treasury Secretary Jim Baker III. Complex systems (stock markets) can be felled by simple actions (herd mentality).
- Our experiences are infinitesimal compared to the size of the universe. But our decisions are based almost entirely on OUR experiences.

## Basic utilities backed by complex systems



Source: ifixit, MRO Network

## Complex systems felled by simple actions

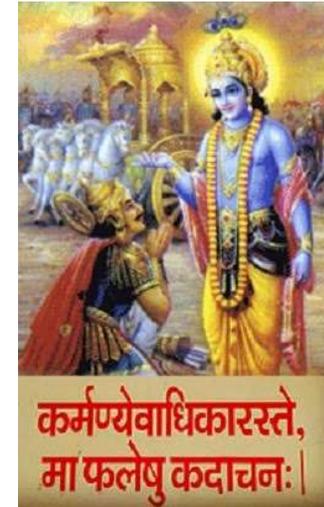


Source: Wikipedia

# THE PHILOSOPHY OF SIMPLICITY

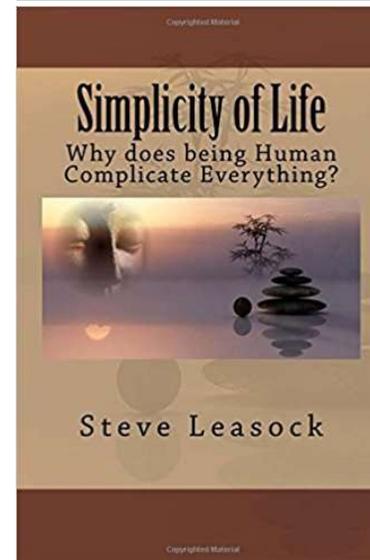
- Simplicity has deep roots in philosophy and mythology. Detachment from material pleasures is a known concept across ancient Greek and Indian texts.
- Stoicism centers around accepting the present without desires of pleasure or fear of pain. The Gita speaks of doing one's duty without expecting results.
- As the world grows increasingly complex, it is still possible for us to adhere to simple values in life. Simplicity also, therefore, has a deep connect with spirituality and how we live our lives.
- Frugality is an associated concept that also has deep philosophical and spiritual roots from the Buddha to Socrates, Rousseau, and Thoreau.
- "Remember: very little is needed to make a happy life." [Marcus Aurelius]
- "If we could only see that our smallness *is* what makes us great, perhaps we wouldn't need to *pretend* to be great by our inflation or grandiosity." [Michael Gellert]

## The Bhagavad Gita emphasizes duty



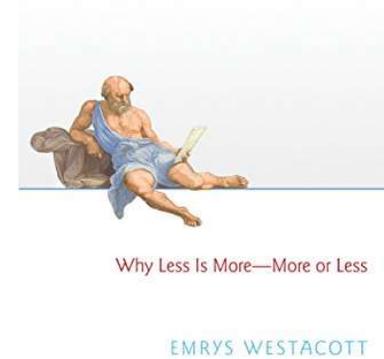
Source: gitablog.com

## Simplicity also has a spiritual aspect



Source: Amazon.com

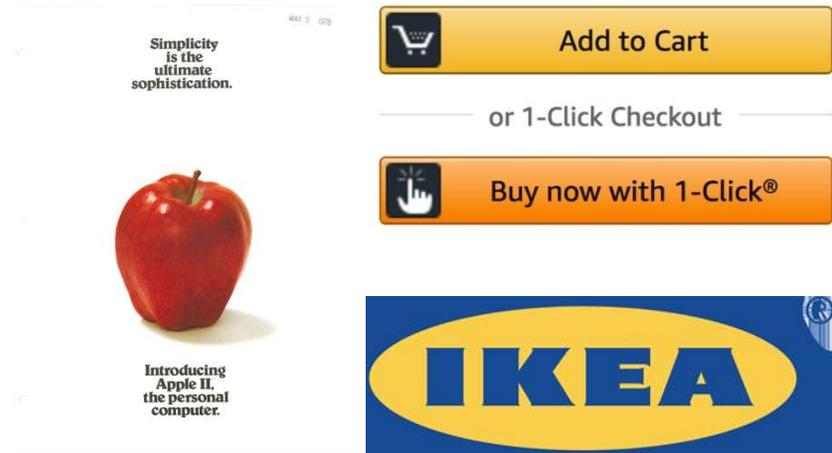
## The Wisdom of Frugality



# SIMPLICITY WINS IN BUSINESS

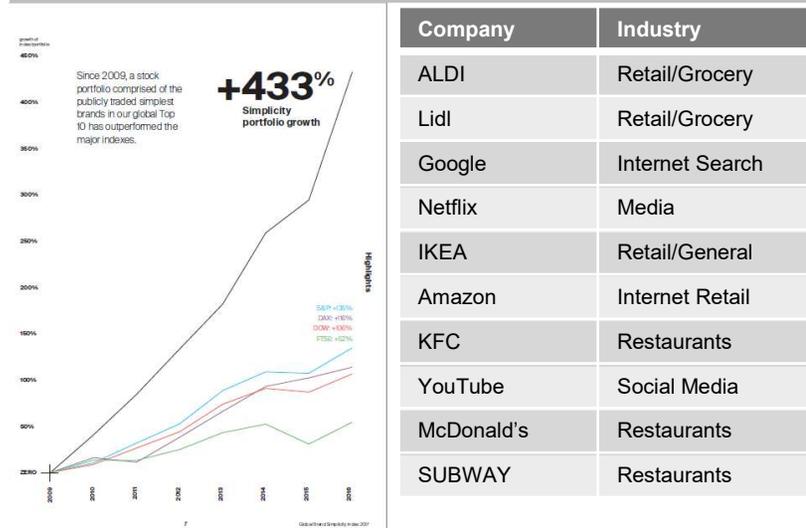
- In the 1950s, Paul Meehl showed that the mechanical method (formal, algorithmic) performed as good as clinical methods (subjective, informal). Simple rules can perform much better than expert intuition.
- Wharton professor Philip Tetlock showed in his 2006 book that the average expert was only slightly better at predicting the future than a layperson using random guesswork.
- Some of the world's most famous, most celebrated brands today underscore simplicity of design (Apple) and use (Amazon one-click). Ikea includes simplicity as one of its value.
- Steve Jobs: "It takes a lot of hard work to make something simple, to truly understand the underlying challenges and come up with elegant solutions."
- A portfolio of the world's Top 10 largest brands ranked on simplicity also outperformed global equity benchmarks.
- As per Global Brand Simplicity Index, 64% of consumers are willing to pay more for simpler experiences

## Apple, Amazon, Ikea – ideas of simplicity



Source: computerhistory.org, GeekWire, Ikea

## Simple brands outperform benchmarks



Source: Global Brand Simplicity Index 2017

# SIMPLICITY WINS IN INVESTING

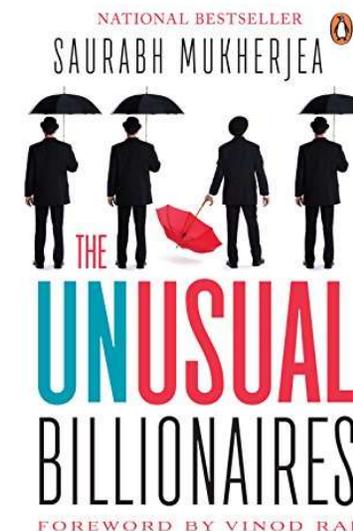
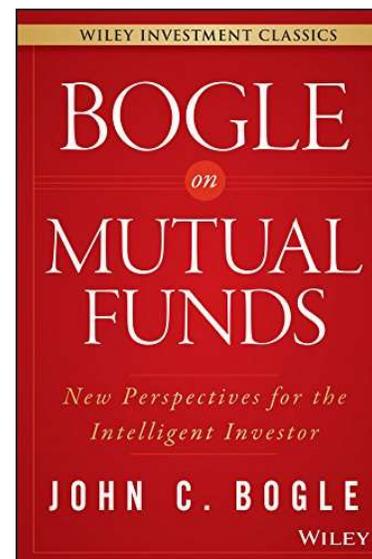
- **Simplicity has also been espoused by investment gurus like Warren Buffett - “I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will”, and Peter Lynch - “The simpler it is, the better I like it”.**
- **Vanguard founder John Bogle’s advice: Split your investment equally between a stock index fund and a bond index fund, and “hold on your positions as long as you live”. One of his twelve pillars of wisdom was, “When all else fails, fall back on simplicity”.**
- **Warren Buffett’s investment philosophy centers on buying great franchises with moats at reasonable valuations and holding on to them for his favorite holding period “forever”.**
- **Does simplicity work? Investment Manager Ben Carlson (‘A wealth of common sense’) showed that the Bogle Model (index fund portfolio of 40% US stocks, 20% international stocks, and 40% US bond market) beat highly sophisticated US college endowment funds.**

## How the Bogle model beat endowments

| Fiscal end June 30 <sup>th</sup> 2016 | The Bogle Model | Average Endowment | Top Quartile Endowment | Top Decile Endowment |
|---------------------------------------|-----------------|-------------------|------------------------|----------------------|
| 3 Years                               | 6.4%            | 5.2%              | 6.3%                   | 6.6%                 |
| 5 Years                               | 6.5%            | 5.4%              | 6.2%                   | 6.6%                 |
| 10 Years                              | 6.0%            | 5.0%              | 5.3%                   | 5.4%                 |

Source: <http://awealthofcommonsense.com/2017/02/how-the-bogle-model-beats-the-yale-model/>

## Keep your investment philosophies simple



# DEVELOPING A SIMPLE MODEL FOR INVESTING

- **1: Avoid group-think**
  - Shun social media and minute-to-minute updates, avoid live business TV, do not rely on or read broker research, avoid developing biases, resist the tendency to follow the herd.
- **2: Less judgment, less forecasting, more back-casting**
  - Run extensive filters and screens with past financial data, do not rely on forecasts.
- **3: Develop a simple framework based on quantitative and qualitative factors**
  - Qualitative factors: subjective points like promoter quality
  - Quantitative factors: growth rates, ROCEs, etc.
- **4: Ask the right questions**
  - Probe promoters to gauge their intent
- **5: Venture into uncharted territory**
  - Invest in small/midcaps, frontier markets, etc.
- **6: Make time your friend:**
  - Avoid trading, hold for the long-term

## Jim O'Shaughnessy's simple truths

The screenshot shows a Twitter thread by Jim O'Shaughnessy (@jposhaughnessy) from May 10. The tweets contain the following text:

1/ I have been a professional investor for over 30 years. What follows is some things I think I know and some things I know I don't know. Let's start with some things I know I don't know.

2/ I don't know how the market will perform this year. I don't know how the market will perform next year. I don't know if stocks will be higher or lower in five years. Indeed, even though the probabilities favor a positive outcome, I don't know if stocks will be higher in 10 yrs.

3/ DO know that, according to Forbes, "since 1945...there have been 77 market drops between 5% and 10%...and 27 corrections between 10% and 20%." I know that market corrections are a feature, not a bug, required to get good long-term performance.

4/ I do know that during these corrections, there will be a host of "experts" on business TV, blogs, magazines, podcasts and radio warning investors that THIS is the big one. That stocks are heading dramatically lower, and that they should get out now, while they still can.

5/ I know that given the way we are constructed, many investors will react emotionally and heed these warnings and sell their holdings, saying they will "wait until the smoke clears" before they return to the market.

6/ I know that over time, most of these investors will not return to the market until well after the bottom, usually when stocks have already dramatically increased in value.

7/ I think I know that, at least for U.S. investors, no matter how much stocks drop, they will always come back and make new highs. That's been the story in America since the late 1700s.

8/ I think I know that this cycle will repeat itself, with variations, for the rest of my life, and probably for my children's and grandchildren's lives as well.

9/ Massive amounts of data have documented that while the world is very chaotic, the way humans respond to things is fairly predictable.

10/ I don't know if some incredible jump in evolution or intervention based upon new discoveries will change human nature but would gladly make a long-term bet that such a thing will not happen. ([www.longshots.org](http://www.longshots.org))

11/ I don't know what exciting new industries and companies will capture investor's attention over the next 20 years, but I think I know that investors will get very excited by them and price them to perfection.

12/ I do know that perfection is a very high hurdle that most of these innovative companies will be unable to achieve.

13/ I think I know that they will suffer the same fate as the most exciting and innovative companies of the past and that most will crash and burn.

14/ I infer this because "about 3,000 automobile companies have existed in the United States" ([en.wikipedia.org/wiki/Automotive](http://en.wikipedia.org/wiki/Automotive)...) and that of the remaining 3, one was bailed out, one was bought out and only one is still chugging along on its own.

15/ I know that, as a professional investor, if my goal is to do better than the market, my investment portfolio must look very different than the market. I know that, in the short-term, the odds are against me but I think I know that in the long-term, they are in my favor.

16/ I do know that by staking my claim on portfolios that are very different than the market, I hope and will continue to have far higher error rates than other professionals, especially those with a low tracking error target.

17/ I know that I can not tell you which individual stocks I'm buying today will be responsible for my portfolio's overall performance. I also know that trying to guess which ones will be the best performers almost always results in guessing the wrong way.

18/ I know that as a systematic, rules-based quantitative investor, I can negate my entire track record by just once emotionally overriding my investment models, as many sadly did during the financial crisis.

19/ I think I know that no matter how many times you "prove" that we are saddled with a host of behavioral biases that make successful long-term investing an odds-against bet, many people will say they understand but continue to exhibit the biases.

20/ I think I know the reason for the persistence of these "cognitive mirages" is that up to 85% of our investment choices are determined by genetics and can not be educated against. ([researchgate.net/publication/22...](http://researchgate.net/publication/22...))

**Why Do Individuals Exhibit Investment Biases? | R...**  
Request Article PDF on ResearchGate | For a long list of investment "biases," e.g., home bias, loss aversion, and performance chasing, we find that genetic differences

21/ I think I know that if I didn't adhere to an entirely quantitative investment mythology, I would be as likely—maybe MORE likely—to giving into all these behavioral biases.

22/ I know I don't know exactly how much of my success is due to luck and how much is due to skill. I do know that luck definitely played, and will continue to play, a fairly substantial role.

23/ I don't know how the majority of investors who are indexing their portfolios will react to a bear market. I think I know that they will react badly and sell out of their indexed portfolio near a market bottom.

24/ I think I know that the majority of active stock market investors—both professional and aficionado—will secretly believe that while these human foibles that make investing hard apply to others, they don't apply to them.

25/ I know they apply to me and to everyone who works for me.

26/ Finally, while I think I know that everything I've just said is correct, the fact is I can't know that with certainty and that if history has taught us anything, it's that the majority of things we currently believe are wrong.

11:17 PM - 10 May 2018

Source: Jim O'Shaughnessy, Chairman & Chief Investment Officer, OSAM LLC.  
Twitter: <https://twitter.com/jposhaughnessy/status/994631936181264384>