

A  
WEALTH OF  
COMMON  
SENSE



WHY SIMPLICITY TRUMPS COMPLEXITY  
IN ANY INVESTMENT PLAN

BEN CARLSON

**Bloomberg**  
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# **A Wealth of Common Sense**

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*For Cortney and Libby, who make me smile every single day.*

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## **Introduction:**

### **Why Simplicity Is the New Sophistication**

In 1776, Thomas Paine, a political activist, philosopher, and poet published a simple pamphlet that likely altered history as we know it. The title of his publication was plain and simple—*Common Sense*. This tiny pamphlet, which numbered less than 90 pages, inspired the original 13 colonies to seek their independence from Great Britain and form the United States of America. It's been said that virtually every rebel read, or at least listened to, the words written by Paine. This was Paine's introduction to *Common Sense*:

In the following pages I offer nothing more than simple facts, plain arguments, and common sense; and have no other preliminaries to settle with the reader, than that he will divest himself of prejudice and prepossession, and suffer his reason and his feelings to determine for themselves; that he will put ON, or rather that he will not put OFF, the true character of a man, and generously enlarge his views beyond the present day.<sup>1</sup>

Paine's simple words ignited the people of that day to fight for their independence. As John Quincy Adams, the second president of the United States, once said, “Without the pen of the author of *Common Sense*, the sword of Washington would have been raised in vain.” Paine's plain, common sense arguments provided the motivation that was so desperately needed to unite people from all walks of life to stand together in their cause. So why did Paine's words resonate with so many people? In a word—simplicity. Many writers of that day and age used dense philosophy and Latin to get their point across. Paine made his case for the benefits of independence by using clear, concise language that everyone could understand. *Common Sense* worked well with the crowds in the taverns, but was sophisticated enough to be given credibility by the Colonial dignitaries.<sup>2</sup> His words lived up to the title, as common sense works on a number of levels.

Improving long-term investment results by bridging the gap between sophistication and simplicity is the point of this book. Much of the financial advice out there these days might as well be written in Latin because it comes across as another language to most investors. The financial crisis from 2007 to 2009 left some lasting scars on investors' psyches. Many don't know how to proceed or whom to trust. My goal with this book is to provide a resource that helps all investors make more informed decisions using simplicity and common sense, two things that are severely lacking in the financial industry, as a guiding framework to help alleviate some of the lasting damage from the market crash. There is an assumption that complex systems such as financial markets must require complex investment strategies and organizations to succeed. This is a false premise that far too many both inside and outside of the industry have come to believe. Most of the advice out there these days works against investors and their goals because those giving it don't have an understanding of the needs and desires of their audience.

I've spent my entire career working in portfolio management. This experience has taught me that less is always more when making investment decisions. Simplicity trumps complexity. Conventional gives you much better odds than exotic. A long-term process is more important than short-term outcomes. And perspective goes much further than tactics. Tactics are useless to investors in a matter of days—sometimes in a matter of hours. But perspective is something that stays with the investor for a lifetime. It allows you to adapt to the changing market and economic landscape. While keeping it simple won't make it any easier to predict the future—no one has a crystal ball—it can give you the necessary capacity to make rational decisions, no matter what happens next.

There are two working definitions of perspective and both apply to making better financial decisions:

1. Context: A sense of the larger picture of the world, not just what is immediately in front of us.
2. Framing: An individual's unique way of looking at the world, a way that interprets its events.<sup>3</sup>

Perspective is so important because, without it, even the most intelligent of investors can be ruined from a lack of self-awareness in their own abilities. Investors that fail to put the news or market moves into the proper context in regards to their own personal circumstances are fighting an uphill battle. And how you frame the world around you determines how certain events will affect your reactions to outside factors that can impact your financial decisions. Combining a lack of context with a misinformed view of the way the world works is a sure path to failure with a portfolio of investments in the financial markets. A proper perspective can give the investor the right frame of mind to be able to ignore news headlines and avoid acting on the damaging emotions that can hurt the decision-making process.

I'm not here to sell you a pot of gold at the end of a rainbow. I can't offer you a secret get-rich-quick formula for making millions of dollars overnight. The real secret is that there is no secret to be able to make millions of dollars overnight. It only happens over a period of time. Building wealth takes patience. You can't be in a hurry. Fred Schwed, a financial writer who worked on Wall Street during the Great Depression, once said, "Speculation is an effort, probably unsuccessful, to turn a little money into a lot. Investment is an effort, which should be successful, to prevent a lot of money from becoming a little."

The financial markets are like any other marketplace that brings together buyers and sellers looking to find and create value. If you understand how the markets work, and more importantly how the human brain works, the results over time can be impressive. The process does not have to be based on degree of difficulty. The goal is to gain financial independence, pay for your child's college education, go on more vacations, have more time to do what you love, or whatever your needs and desires may be. Remember, the markets are not just about building wealth and making money. They're a tool for your desires about creating freedom, time, memories, and peace of mind. These things are all attainable, as long as you have a plan in place and are able to get

out of your own way.

Complexity tends to be the default option that gets used to persuade investors to buy unnecessary investment products while the vast majority of people really just need to understand more conventional options to succeed. Working with the most sophisticated portfolio strategies over the past decade has given me the ability to interpret the issues that investors should actually pay attention to as opposed to those that are used as an illusion of intelligence and control.

## Noise

The information available to everyone on the planet is growing at an exponential rate. Anyone with a smartphone today has better mobile phone capabilities than the president of the United States did 25 years ago. We have better access to information than the president had 15 years ago.<sup>4</sup> We now have an unprecedented amount of information at our fingertips anytime we want it. There's up-to-the-minute, 24-hour news coverage. We can communicate with anyone we want no matter where they live through e-mail or social media at the click of a button. Every financial market from around the globe can be followed on a tick-by-tick basis. We can now trade stocks on our smartphones. There's no way to escape the deluge of news and financial information that the media throws at you.

Nobel Prize-winning psychologist Daniel Kahneman showed in his research that because of a bias called the affect heuristic, the human brain is very quick to make judgments and decisions based on intuitive feelings that require little thought or deliberation. The sheer amount of information available today makes it easier than ever to use these quick hunches to tell us how to act. There are times when this type of response can work in your favor, but investing is not one of them. Kahneman also found that there is another part of the brain that is much more effective in using a logical and deliberate process to think things through. This is the part of the brain that should be used for thoughtful, deliberate financial decisions. Kahneman says, "If there is time to reflect, slowing down is likely to be a good idea."<sup>5</sup>

Information flow will only continue to speed up in the future, so we have ourselves a conundrum. It will become more and more important to separate the meaningful from the meaningless as most people will be continuously trying to drink from the fire hose of information instead of focusing on the truly important areas that they can control. This illusion of control is more likely when many choices are available, there is a large amount of information available, and you have a personal stake in the outcome of the choice.<sup>6</sup> This is basically a description of the portfolio management process. We all like to think that more choices must be better, but as the number of choices grows, so, too, do the number of decisions and the likelihood of making a mistake.

For example, there are now over 77,000 mutual funds to choose from worldwide.<sup>7</sup> As the number of investment options available to investors continues to increase there is the assumption that complex approaches must be better. In fact, I will show that less is always more and trying to implement a more interesting or clever portfolio strategy is

akin to threading the needle. Sure, it *can* work, but trying harder and increasing the number of decisions you make only increases the odds that you'll make a mistake.

The financial markets are a messy, complex system that is constantly evolving. But the answer to a complex system isn't necessarily a complex investment portfolio that requires constant activity. On the contrary, the best response to the complexities inherent in the markets is a portfolio management process that relies heavily on simplicity, transparency, and reduced levels of activity. One of the ultimate status symbols in the financial world is to consider yourself a sophisticated investor. This word invokes feelings of superiority and privilege. Sophistication is defined as having a great deal of experience, wisdom, and the ability to interpret complex issues. But sophistication does not mean that you have to utilize complexity, just that you understand it. Nassim Taleb explains this dynamic in his book *Antifragile*:

A complex system, contrary to what people believe, does not require complicated systems and regulations and intricate policies. The simpler, the better.

Complications lead to multiplicative chains of unanticipated effects. [. . .] Yet simplicity has been difficult to implement in modern life because it is against the spirit of a certain brand of people who seek sophistication so they can justify their profession.<sup>8</sup>

In his classic book, *Winning the Loser's Game*, investor and author Charles Ellis shares the tale of his two best friends. Both were at the peak of their careers in the medical field, each with a distinguished track record. The two friends agreed that there were two discoveries in the field of medicine that were far and away the most important breakthroughs in enhancing people's health and longevity—penicillin and having doctors and nurses wash their hands. Ellis concluded this story by sharing the lesson that advice doesn't have to be complicated to be good.

## How Hard Can It Be?

Over the course of my career I've invested in, advised on, or performed due diligence on nearly every investment strategy, asset class, security, or product type that you could think of. You name it; I've been involved with it in some fashion. I've worked with high-net-worth individuals, low-net-worth individuals, and million- and billion-dollar institutional portfolios. One thing I can say for certain through this experience in the markets is that it is not easy being an extraordinary investor. It's quite rare and extremely difficult.

How difficult? Neurologist-turned-investor and author William Bernstein says that there are four basic abilities that all investors must possess in order to be successful: (1) An interest in the investing process, (2) math skills, (3) a firm grasp of financial history, and (4) the emotional discipline to see a plan through. Bernstein doesn't have much faith in the prospect of most investors in the pursuit of excellence; he states, "I expect no more than 10 percent of the population passes muster on each of the above counts. This suggests that as few as one person in ten thousand (10 percent to the 4th power) has the full skill set."<sup>9</sup>

I agree with Bernstein that there is only a very small subset of investors that have the combination of skills he lists as well as the ability to achieve extraordinary investment returns. Not only does it require intelligence, a solid investment process, and an ability to think differently than the crowd, it also requires a dose of luck in many cases. This is why the majority of investors shouldn't be shooting for extraordinary. Legendary investor Benjamin Graham once said, "To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks." This is the problem most investors face—they are in constant search of superior results but they do not have the internal wiring, time, or skillset necessary to create that type of performance. Satisfactory results can actually allow you to be above average and beat 70 to 80 percent of all other investors. And it's much easier than most assume. You first have to give up on the dream of superior performance and realize only a small fraction of investors every actually get there. And most don't stay on top either (more on this later in the book).

The problem for average investors is that when they aim for superior results, it more often than not leads to below-average performance. It's amazing how easy it is to do worse by trying to do better. The single greatest challenge you face as an investor is handling the truth about yourself. This is why it's an unrealistic goal for the average investor to try to become the greatest investor in the world. A far more worthy goal is being better than average, which is totally realistic and achievable. Better than average can lead to impressive results in terms of investment performance over long enough time horizons. It's all about harnessing the power of thinking long-term, cutting down on unforced errors, and having the patience to allow compound interest to work in your favor.

The question is: How does one go about this?

Here is some standard investment advice that is both simple and effective:

1. Think and act for the long term.
2. Ignore the noise.
3. Buy low, sell high.
4. Keep your emotions in check.
5. Don't put all of your eggs in one basket.
6. Stay the course.

These are all great pieces of advice. The question is *how*. How do I know what long term even means for me? How do I buy low and sell high? How do I keep my emotions out of the equation? How do I diversify my portfolio correctly? How do I stay the course and reduce the noise that finds its way into my portfolio? These are the questions I seek to answer throughout this book. *What* to do is not nearly as important as *how* to do it.

The biggest problem for most people is that good investment advice will always sound the best and make the most sense when looking back at the past or planning ahead for the future. It will rarely sound so great in the moment when you actually have to use it.

As you will see throughout, this is both extremely simple, but maddeningly difficult at the same time. As Warren Buffett once said, “Intelligent investing is not complex, though that is far from saying it is easy.”

This line sums up the point of this book very well.

## Notes

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## CHAPTER 1

# The Individual Investor versus the Institutional Investor

*When “dumb” money acknowledges its limitations, it ceases to be dumb.*

—Warren Buffett

I was fresh out of college and in the early days of my career in the money management industry, but I could tell this talk was a big deal. It was one of my first big industry conferences and it was standing room only. The room was packed with professional investors, portfolio managers, and consultants, all eagerly awaiting the message to be delivered by a well-known billionaire hedge fund manager. There was a buzz in the air. At every investment conference there is always one speech that every attendee circles on their agenda. This was that speech.

After taking the podium and making the customary break-the-ice joke, the headline speaker got right into his speech. It covered a wide variety of topics on the markets and the investment industry in general. It was very data driven, but interesting and even funny at times. You could tell that he had plenty of practice over the years speaking to large crowds such as this one. There were no note cards or PowerPoint slides. It was like you were having a one-on-one conversation with a business associate. Everyone around me was frantically scribbling away in their notebooks so they could look back on his words of wisdom in the future. Once the bulk of the current market outlook was through he decided to spend some time going over the big changes he foresaw in the investment management industry in the coming years.

He made the claim that many of the best, academically tested, evidence-based investment strategies from the past—once only reserved for the wealthy elite at a very high cost—would soon become available to all investors through low-cost exchange-traded funds (ETFs) and mutual funds that could be instituted on a systematic, quantitative basis. At the time ETFs were still a relatively new product, so this was somewhat of a bold call that not many were making at the time. He was predicting a sea change in the industry.

In way of background on ETFs, the industry has experienced explosive growth in assets under management in the past decade and a half. ETFs in all financial asset classes carried only \$70 billion in assets in the year 2000. By the end of 2014, that number was closer to \$2 trillion, an unbelievable growth trajectory.<sup>1</sup> For the uninitiated, an ETF is very much like a mutual fund in that it allows you to hold a number of different securities under a single fund structure. This allows investors to buy a diversified pool of securities so you don't have to buy them each individually. The biggest difference is that ETFs trade on the stock exchanges throughout the day, just like individual stocks, whereas mutual funds transactions only happen at the market close. ETFs are also structured in a way that makes them very tax and cost efficient, so they're cheaper, on average, than mutual funds. ETFs have better transparency of their holdings than mutual funds, as you can view ETF holdings on a

daily basis. They aren't nearly as affected by forced buying and selling as mutual funds can be.<sup>2</sup> ETFs are allowing enterprising fund companies to slice and dice risk factors, sectors, regions, and asset classes in a number of interesting ways. This should only continue in the future, as these strategies will become more and more specialized. ETFs are worth paying attention to as they will only carve out an ever-larger market share of investor dollars over time.

Back to the investment conference: I found myself nodding in agreement with this fund manager as he surgically laid out the reasoning behind the potential shift to make better investment strategies available at a lower cost to more and more investors—increased competition, availability of information, a dearth of academic studies on back-tested strategies, and the fact that most professional portfolio managers came from similar schools of thought. This was making it harder and harder for portfolio managers to justify their claims of superior investment processes at a much higher cost to the individual investor. The line of thinking was that these newer products wouldn't offer the possibility for enormous outsized gains, but at a reduced cost to the investor, would give similar returns on a net basis after costs, the only thing that really matters in the end.

When the speech was over, there was a Q&A session that gave the professional investors in the room a chance to follow up with this hedge fund manager about his speech. Participants quickly hurried to the microphones to ask this famous investor a question. The first audience member, looking a little flustered, didn't waste any time as he asked, "How are we ever supposed to sell these lower cost funds to our clients? Won't this be an admission that we're buying sub-par funds?" As I looked around the room I noticed nearly every other investor nodding their head in agreement. One by one they all took their turn asking similar questions.

"How can we justify the use of inferior funds?"

"Don't you understand that you get what you pay for?"

"How do we prove our value-add when selecting these types of funds?"

"How could we ever sell the fact that we're not buying the best of breed funds at the highest cost? We might as well admit we don't know what we're doing!"

At first, this reaction by my fellow, more experienced investors, made absolutely no sense to me. Why wouldn't they be thrilled about the fact that certain strategies would now be much more accessible at a lower cost in a more shareholder-friendly investment vehicle? Wasn't the investment industry becoming flatter and more cost-effective a good thing for advisors, consultants, and investors alike?

Then I started to realize my naiveté. I was still a rookie in the field of finance. Not everything works in black and white when it comes to products and investment choices in the financial services industry. All of the pros in the room were thinking about the same thing—signaling. If they were using inferior products at a lower cost, they would be signaling to their clients that they weren't doing their job to uncover the best investment products available in the marketplace. These investors and allocators of capital were worried about becoming marginalized. If they couldn't offer access to

only *the best funds*, then how would that look to current and potential clients? If you have your name on the list at the best nightclub in the city, you're in exclusive company. But if that velvet rope is open to everyone that wants to get in, suddenly the shine comes off just a bit and you don't feel so special anymore. Also, you get what you pay for is an expensive theory, but one that all too many still believe in. It's more or less a sales tactic, but one with a narrative that's difficult to shake for many both inside and outside the industry.

It was far too counterintuitive for these investors to accept the fact that they could earn above average returns at a lower cost while giving up the opportunity for extraordinary performance at a much higher cost. The extraordinary performance was much harder to get and there was no way that all of them were going to be able to succeed in finding it, but how could they admit this fact and not even try? These are very competitive people. They all went to top colleges and universities. Most attended the top business schools, obtained the prestigious CFA designation, or both. Everyone in the room was intelligent and extremely qualified. Investing can be a cutthroat business. Everyone wants to be the best investor by making the most money possible in the shortest amount of time. Unfortunately, it's just not possible for every single professional investor to be in the top echelon of the performance rankings. This can be a difficult realization to come to.

The look on the speaker's face was priceless after he finished answering the final round of angry questions from the audience. He had a smirk on his face. It was almost like he knew what was coming for many of these investors based on their reactions. He knew it was only a matter of time before market participants came around to his line of thinking. But breaking established viewpoints on the markets can be difficult for intelligent people. It's not easy to admit that there might be another way of doing things, a simpler approach.

Luckily, individual investors don't have to worry about entrenched positions from the investment industry. You don't have to try to impress anyone. You don't have to invest in the Rolls Royce of portfolios to reach your goals. A more economical, fuel-efficient model will do the trick as long as you're not worried about impressing anyone else (which you should not be). It's about getting from point A to point B, not how you get there. There are no style points when investing. There's no bonus for degree of difficulty. You don't have to signal that you invest only in the best, most exclusive strategies. No one is there to judge you or your portfolio and you don't have to compete against your peers. The most important thing is that you increase your probability for success. That's all.

Coming to this realization can be a huge weight lifted off your shoulders because, as you'll see in the next section, being in the upper echelon of investors is nearly impossible for even the professionals that do this for a living.

## **Institutional versus Individual Investors**

Professional investors now control the markets, but it wasn't always like this. Fifty years ago, the little guy controlled the stock market, as individuals made up more than

90 percent of trading volume on the New York Stock Exchange. Today those roles are reversed, as institutions handle more than 95 percent of all trades in listed stocks while trading almost 100 percent of all other investable securities. Institutional investors such as pension funds, endowments, foundations, sovereign wealth funds, and wealthy family offices have trillions of dollars at their disposal to invest.<sup>3</sup>

Warren Buffett is probably the most well-known investor to the average guy or gal on the street. Not as many individual investors know who David Swensen is. Swensen is Warren Buffett in the world of institutional money management. He's one of the greatest institutional investors of all time. Swensen literally wrote the book on the institutional investment model, called *Pioneering Portfolio Management*. They even call his style of portfolio management, which has been imitated by hundreds and hundreds of investment funds around the globe, the Yale Model, because he is the chief investment officer for the Yale University endowment fund. Swensen has earned Yale nearly 14 percent per year in gains since the mid-1990s, an unbelievable run of performance over two decades.

Yale's portfolio is currently valued at over \$20 billion. For those wishing to replicate Swensen's success, it's worth noting the structure of Yale's endowment fund. The school brings in hundreds of millions of dollars a year in charitable donations and grants. Ivy leaguers love giving back to their alma maters. Yale has a staff of 26 fulltime investment professionals who specialize in particular areas of expertise for the portfolio. Plus, Yale is a tax-exempt organization, meaning they don't have to worry about tax implications when it comes to their portfolio decisions. They also have a time horizon of forever, more or less, as the endowment is a perpetuity to the school. Large institutions, such as Yale, have access to certain funds that most average investors can't invest in because the minimums are far too large. There are deals that the largest players in the industry are involved in that would never become available to individual investors. Large pools of capital get a foot in the door simply for having such so much money at their disposal. The scale of these funds allows them to pay less in fees as a percentage of assets through negotiations because the absolute amounts can be so large.

While it's important to distinguish between individual and institutional investors, Swensen is quick to point out that even within the rank of professional investors there is a hierarchy. In the Yale Investment Office's 2013 annual report, Swensen offered the following advice to both institutional and individual investors alike (emphasis mine):

The most important distinction in the investment world does not separate individuals and institutions; the most important distinction divides those investors that have the ability to make high-quality active management decisions from those investors without active management expertise. Few institutions and even fewer individuals exhibit the ability and commit the resources to produce risk-adjusted excess returns.

The correct strategies for investors with active management expertise fall on the opposite end of the spectrum from the appropriate approaches for investors without active management abilities. Aside from the obvious fact that skilled active