THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

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By Nimesh Chandan

Antiquity rhymes with Opportunity

"Events of future history will be of the same nature — or nearly so — as the history of the past, so long as men are men."

- **Thucydides, the father of 'scientific history' (460-400BC) .... (yes, that far back!)**

In 1708, during the Great Northern War, the Swedish army invaded Russia under the leadership of King Charles XII. It was a harsh winter and the Russian retreated while adopting the scorched earth strategy (which involves destroying any resources the enemy can use on the way). Many of the Swedish troops had a difficult time surviving the severe conditions. By the time, they caught up with the Russians in the battle of Poltava, the size of the Swedish army had reduced from 35,000 to 19,000 and they ultimately lost and surrendered in June 1709.

In June 1812, Napoleon's 'Grande Armée' of 610,000 men invaded Russia. The Russian army adopted the same strategy. They retreated and again burnt their crops and villages, denying the enemy their use. Napoleon did capture Moscow but could not get the Russians to surrender. During winter, the army lacked food, horses lacked fodder, and ultimately the army was reduced to 100,000. The French army suffered even more disastrous losses on the retreat from Moscow.

In 1941, during World War II, Germany attacked Russia before the onset of severe winter weather. Hitler and the German General Staff did not expect it to be a long campaign and hence no preparations (like warm clothing for the army and getting vehicles winter-ready) were made. Russians were better adapted to fighting in winter conditions. In the battle of Moscow, the Russians benefitted from the

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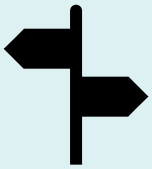
harsh winter conditions which crippled the German army. Germany lost more than 700,000 men in the invasion.

It is important to learn from history. George Santayana wrote, *"Those who cannot remember the past are condemned to repeat it".* And pay a huge price for it too! The same is true for the investment world. Along with market concepts and businesses, one must also learn about the financial history.



THE BOOM BUST CYCLE

The financial history is adequately populated with boom-bust cycles and repetition of these cycles makes one believe that history repeats itself. However, in each of the cases the underlying theme, financial asset, participants, events are different. Then what causes the recurrence? Let's consider the following three quotes which have been given by market observers or participants, but almost a century apart from each other (yes, like the Russian invasions):

"In reading The History of Nations, we find that, like individuals, they have their whims and their peculiarities, their seasons of excitement and recklessness, when they care not what they do. ...that millions of people become simultaneously impressed with one delusion, and run after it, till their attention is caught by some new folly more captivating than the first." This is from the book Extraordinary Popular Delusions and the Madness of Crowds, by Charles Mackay, first published in 1841.

"Wall Street never changes, the pockets change, the suckers change, the stocks change, but Wall Street never changes, because human nature never changes." Jesse Livermore quoted sometime in the early 1900s.

"... but financial crises follow a rhythm of boom and bust through the ages. Countries, institutions and financial instruments may change across time, but human nature does not". This is from the book 'This time is different' by Reinhart and Rogoff published in 2009.

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The financial market cycles are primarily investor behavior cycles. Human nature doesn't change and causes the recurrence of past patterns. While economic and business cycles also play a role in the market movement for sure, it is the investors behavior that a) exaggerates the market movement on either side by adding overreaction and b) influences, to some extent, the future course of business cycle in the direction of its bias (Read about reflexivity here). Understanding investor behavior and its divergences from rationality hence, become extremely important for success in investing. Understanding the crowd psychology enables an intelligent investor to benefit from it. While the general sentiment is down during economic slowdown and market crashes, good investors are busy picking up bargains. The seeds of wealth are sown during such downturns. On the other hand, during economic boom and investor euphoria, it is slim pickings for a good investor and in fact these times become an opportunity to harvest the gains.

HISTORY RHYMES

Human nature, that causes the market cycles, is also the cause of uncertainty in market movement. As Mark Twain said, *"History doesn't repeat itself, but it does rhyme".* That poses a challenge. Investors who undermine history easily succumb to the error of 'this time it's different'. Investors who expect history to repeat precisely like the past, fall prey to another wrong assumption, *"Everything is always the same".* The future will not unfold exactly as the past, it will have some similarities though. If investors who ignore history are bound to repeat the previous mistakes; investors who expect precision will learn the hard way, that *"Markets can remain irrational longer than one can remain solvent".*

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Anchoring-and-adjustment (by Daniel Kahneman) provides some help in this issue. One can anchor or use the foundation of the basic trend in the cycle (base rates) and then adjust to how much the current situation differs from the previous ones. An example is in order: A cab is involved in a hit-and-run accident at night. Two cab companies, the Green and the Blue, operate in the city. You are given the following data:

- 85% of the cabs in the city are Green and 15% Blue
- A witness identified the cab as Blue. But the court has concluded that under the circumstances, the witness correctly identified the two colors correctly 80% of the time and failed 20% of the time.

What is the probability the Blue cab was involved in the accident?

If there was no witness, the probability of Blue cab being guilty is 15% (base rate or basic trend). Now incorporate the witness testimony (difference in the current situation from base rates or basic trend), which using Bayesian inference comes to 41%.

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Let's take a market example, suppose the Nifty has historically bottomed at a P/E ratio of 12x in various market declines. An investor wants to determine whether that's the level to wait for to invest (don't try this at home … 😉). Here our base rate is 12x P/E where we anchor ourselves. The change in the components over the years have led to a lot of consumer companies entering the index replacing some commodity companies. Typically, incoming consumer companies enjoy higher valuations than outgoing ones. Hence the investor has to 'adjust' the buying P/E ratio upwards to accommodate this change.

WHEN LOOKING BACKWARDS LOOK FURTHER

Some of the other things to take care of while learning from history:

- **Use longer timelines to accommodate rare events:**
  Events that look rare in the last decade may look frequent if you take a larger data set of say a century or more. High debt levels across countries pre and post COVID crisis are not alarming to investors who haven't seen countries default on payment in the past few years. If you take a longer perspective, history is colored with large countries defaulting and that too repeatedly. Larger data set also removes recency bias.

- **Careful about averages:**
  Some events can distort averages considerably. Using an example from Nassim Taleb: Suppose you collect together 1000 people and measure their average height. You then introduce the tallest

man in the country in the group and measure the average height. There will not be much change in the average. But imagine if you are measuring average incomes and you introduce the richest man in the world in the group. This time the observations changes substantially. In the stock markets, during narrow rallies, few stocks take the index levels and index multiples higher. The index may look expensive, but the broad market may actually be available cheap.

- **Don't mistake correlation for causation:**
  When analyzing trends, just because two variables are moving together, it doesn't mean there is a cause-effect relationship between them. India is an oil deficit country and rising oil prices impact current account negatively. However, there are times when the oil prices and Indian indices move up together due to global risk-on trade.

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In a recent interview I was sharing with the host, that I believe, one becomes a better investor after the experience of a complete boom-bust cycle in the financial market. When knowledge of financial history is combined with experience of how the crowd behaves, one is able to position him/herself better in the market cycle.

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ABOUT STOIC INVESTOR:

The word "Stoic" is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the "Stoic investor" as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).