

THOUGHTS FOR THE WEEK

SYSTEMS THINKING FOR INVESTORS

January 28, 2022

Our last *Thoughts for the Week - Wisdom in Correcting*, focused on how investors can cultivate the ability “to self-correct, rather than being forced to correct.” And with the markets correcting as we write this (S&P 500 -10%+ YTD) it seems like a good time to share a few additional thoughts on how we can approach investing in ways that are self-correcting and resilient (Source: The Bloomberg).

Our source this week is one of our favorite books, *Thinking in Systems – A Primer*, by Donella Meadows. Meadows was one of the world’s foremost systems analysts, winner of a MacArthur Foundation “genius” award, and a Pulitzer Prize nominee. *Thinking in Systems* is a rich trove of wisdom and insights into problem solving and understanding and dealing with complex systems – systems like your company, the financial markets, your school, local or national government, or your own family.

We could fill twenty *Thoughts for the Week* with wisdom from *Thinking in Systems* but here are a few nuggets that resonated for us as we re-read it last week:

- Financial markets and the economy are, “self-organizing, nonlinear, feedback systems”. They are understandable only in the most general way and driven by such a complex interaction of factors, variables, and emotions that they are inherently unpredictable and not controllable – at least in the sense that we can’t foresee how they will behave in the future exactly or prepare for them perfectly.
- Complex systems can’t be controlled. As such, Meadows suggests that we are better off, “learning to dance with them”. She goes on to explain that many of her best insights about working with complex systems came from her experiences whitewater kayaking, gardening, playing musical instruments, and skiing. All of these endeavors, “require one to stay wide awake, pay close attention, participate flat out, and respond to feedback.” Financial planning and investing benefit from the same approach (and if you are not going to stay awake, pay close attention, participate flat out, and respond to feedback *yourself* you are likely to be well served by paying someone to do so for you).
- One of the most powerful ways to influence the behavior of a system is through its purpose or goals. Goals are the direction-setters of systems. They determine what is a “discrepancy” that requires action, and if goals are defined badly, or don’t measure what is intended to measure, the system won’t produce the desired results. Meadows states, “Systems, like the three wishes in a traditional fairy tale, have a terrible tendency to produce exactly and only what you ask them to produce. Be careful what you ask them to produce.” In an investing context, it is easy to lose sight of our real goals – freedom from financial worry, creating a stable and growing stream of income, enhancing our children’s financial literacy, or compounding our wealth tax-efficiently over the long-run -- in favor of more immediate, more easily measurable goals, like

“outperforming the market” or keeping up with the S&P. If your only goal is “performance”, beware of the unintended consequences that come from building a system to pursue it.

- Resilience is a measure of a system's ability to bounce back and survive after being pressed or stretched. Resilience in systems arises from a rich structure of feedback loops and buffers that work in different ways to help keep the system in balance and help it self-correct under different conditions. Diversifying your sources of return and holding cash reserves so that you don't have to sell volatile assets during a downturn serve as “portfolio buffers”. Matching future liabilities and sources of cash and stress testing portfolios to see how they are likely to perform on paper before a market decline (especially when you have leverage) serve as “portfolio feedback loops”. And while they may seem unimportant much of the time – just as you don't notice your body's ability to sweat or shiver to maintain your body temperature – their presence can be critical to the long-term welfare of the system. If we strip away these “emergency response mechanisms” because they can appear costly or unnecessary, we may drastically narrow the range of conditions over which the system can survive.

Thinking in Systems is full of practical advice and it concludes with a call for us all to “Expand the Boundary of Caring”, reminding us that in a world of complex, interconnected systems there are practical reasons why what we care about should expand accordingly. “No part of the human race is separate either from other human beings or from a global ecosystem. It will not be possible in this integrated world for your heart to succeed if your lungs fail, or for your company to succeed if your workers fail, or for the rich in Los Angeles to succeed if the poor in Los Angeles fail, or for Europe to succeed if Africa fails, or for the global economy to succeed if the global environment fails. “

That paragraph was written in 2008 but it certainly resonates today.

Enjoy your reading and your weekend – we look forward to continuing the dance with you!

Mike, Cate, Scott, Marina, Oscar, Suzy, and Willis

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Source: *Chapter Seven – Living in a World of Systems*, from *Thinking in Systems - A Primer*, Donella H. Meadows, Chelsea Green Publishing, White River Junction, Vermont Copyright 2008 <https://www.amazon.com/Thinking-Systems-Donella-H-Meadows/dp/1603580557>

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CRC 4235325 dtd 01/28/2022