THOUGHTS FOR THE WEEK

DON'T BE A MIDWIT

October 28, 2022

The Midwit fallacy is a popular meme. The idea is that many problems have simple solutions. The Genius uses immense brainpower to find it. The Simpleton defaults to the simple solution because he / she doesn't know any better. Both the genius and the simpleton land on the correct answer, from different angles. Meanwhile the Midwit, representing the fat part of the bell curve, falls prey to the illusion that the simple answer must be wrong, and therefore comes up with the complex, sophisticated, and wrong solution, despite the simple answer being the correct one.

An example, as pointed out on the blog MD&A in an 8/13/22 posting (link below), is the solution to US housing affordability. The Simpleton says, "Build more houses". The Genius comes to the same conclusion. But the Midwit comes up with an argument such as, "High prices are caused by foreigners and speculators holding properties vacant, and by Airbnb and greedy developers. Therefore, tax vacant units, restrict Airbnb, and require developers to only build affordable housing." While the factors the Midwit cites are impactful, the laws of supply and demand tell you that, yes, building more houses – any houses - would most likely solve the problem.

The Midwit fallacy plagues the investment world. Take the indexing argument. Indexing helps solve problems investors face – the ability (or lack thereof) to discern the better value among a set of choices; the higher return hurdle imposed by paying additional fees; and the increased tax inefficiency often inherent in an active investment strategy. One of the four tenets which underpin the twin goals we employ as stewards of family investment capital (avoid permanent loss of your capital and grow your purchasing power) is to keep costs and taxes low. These are two elements within an investor's control. One cannot control what the market does or what the Federal Reserve chooses to do. But an investor can control for costs and taxes, and indexing improves that control.

Further, indexing offers the average return. While average may seem unattractive (who shouts, "I want average", in a world obsessed with optimization, right?), the average return on stocks has been good enough for most investors. Consider the price return of the S&P 500 has compounded at a rate of 7.3% per year over the last 20 years (as of 10/24, source: Bloomberg). And you get the dividends too. A 7.3% annual return, plus dividends, means your investment capital doubles roughly every 10 years. So, over a 20-year period $100, remaining invested, grows to ~$400. And think about what has occurred over the last 20 years - two American wars, a housing crisis, a near meltdown of the financial system, a Euro crisis, Brexit, a pandemic, oil prices fetching less than $0 per barrel, oil prices fetching more than $100 per barrel, and the current tenuous states of politics and capital markets.

Of course, past performance is not indicative of what the future holds, and we can't be sure what investment returns will look like over the next 20 years. But the odds are that investors will earn at least a satisfactory long-term return by simply investing in a low cost, tax efficient manner such as indexing.

We are not immune to the Midwit problem. Despite favoring simple, efficient solutions, we at times have been lured by attractive and smart sounding complexity. Our worst example was a decision, prior to the financial crisis in 2008, to invest capital in derivatives linked to the return of hedge funds. The pitch sounded good – low volatility of the underlying hedge fund returns would allow an investor to earn excess returns through derivatives. The hypothetical returns “showed” little risk of loss. So, rather than take the simple route – invest directly in assets we can understand and if market prices dip, we can choose to hang on to those assets and wait for recovery – we instead chose to invest a small portion of select client capital into the hedge fund linked derivatives. Shortly thereafter, the financial crisis spun into existence, asset prices took a precipitous fall, the derivative prices unhinged from their underlying assets, and we lost permanent capital on behalf of clients. Midwit thinking on our part.

This is not to say all complexity is bad, whether investing or otherwise. Much as any person prefers a simple homeopathic solution to brain cancer, it’s probably in the afflicted’s best interest to undergo neurosurgery. But too often we believe people fall for the fallacy that just because something is simple it must not be optimal. Ourselves included. So, we guard against this. And in our work on behalf of clients, we seek simplicity. We won’t always arrive at the right answer. But remaining aware of what we don’t know, and of the risks of defaulting to complexity, we think improves overall outcomes.

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Sources: MD&A Blog, “The Midwit Trap”, 8/13/2022
https://philo.substack.com/p/the-midwit-trap?utm_source=substack&utm_medium=email

Mike Burbank has been recognized as one of the Top 400 Advisors in the United States by the Financial Times every year from 2013 through 2020, by Forbes Magazine 2020 list of America’s Best-in-State Wealth Advisors, ranking #27 for California, and the Barron’s list of America’s Top 1,200 Advisors: 2020 State-by-State, ranked #70 in California.

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CRC 5066013 dtd 10/28/2022