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NEWSLETTER

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FEW THOUGHTS ON COMPUNDING - *Anshul Khare*

Most value investors are familiar with the fable of the chess and rice grains. When a king in the ancient times saw the game of chess for the first time, he got so impressed that he offered the inventor of the game to accept a gift.

“Anything that you want.” said the King.

“Your Highness, I want one grain of rice for the first square on the chessboard, and I want you to double that for every subsequent square on the board.”

“That’s it? Are you sure you don’t want anything else because it seems like a very modest ask.” The King said with astonishment.

We all know what happened after that. When the King actually did the calculations, he realized that the quantity of grain required to fulfill the demand was more than the total amount of grain available on the Earth.

This story is often narrated to illustrate the power of compounding. It’s funny that even after hearing this story countless times, I am yet to internalize the non-linear force of compounding. And I am not alone. The more books I read and the more people I interact with, I have concluded that the idea of exponential growth isn’t easy to digest for most people.

Why is it so hard for humans to wrap their head around the concept of compounding and the exponential growth associated with it?

Rolf Dobelli, in his highly entertaining and informative book The Art of Thinking Clearly, argues that for homo sapiens, this inability to deal with non-linear growth has evolutionary reasons. He writes —

“Linear growth we understand intuitively. However, we have no sense of exponential (or percentage) growth. Why is this? Because we didn’t need it before. Our ancestors’ experiences were mostly of the linear variety. Whoever spent twice the time collecting berries earned double the amount. Whoever hunted two mammoths instead of one could eat for twice as long. In the Stone Age, people rarely came across exponential growth. Today, things are different.”

Riddle me this — there’s a lake where lotus flowers start growing at the beginning of the rainy season. The flowers double in count every day. Today is day 1 and there’s one lotus flower in the lake. If the lake is full of flowers on the 50th day, on which day the lake was half full of flowers?

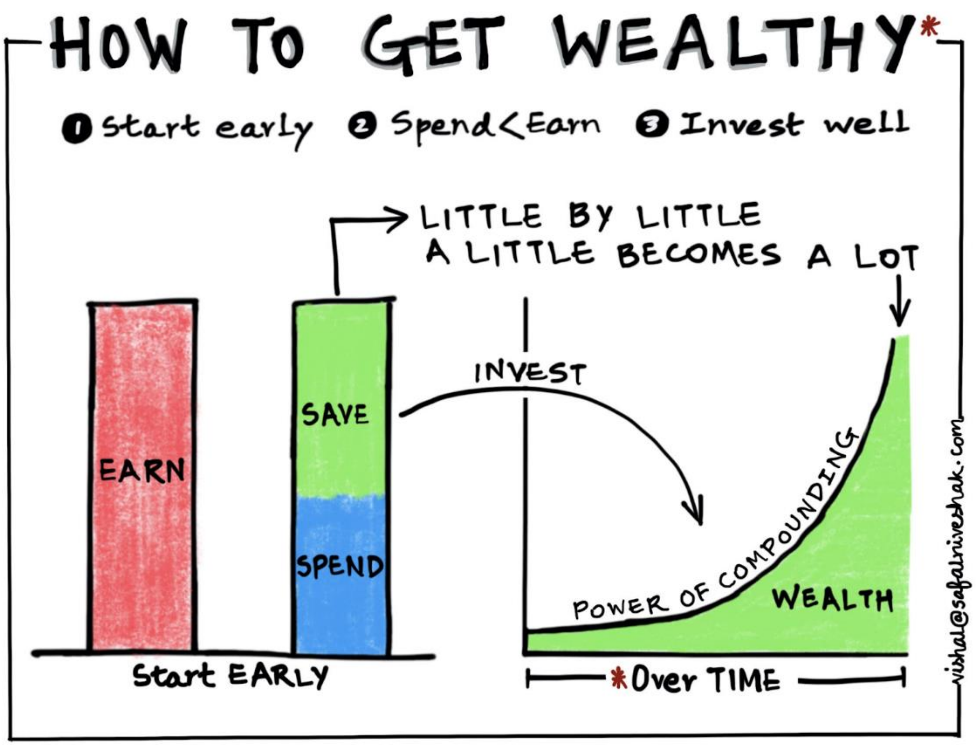
After a moment's thought, most people usually give the right answer. The pond would be half full on the 49th day because the growth equation says that it doubles every day.

Although this was a hypothetical question, if you examine it from the lens of compounding, you'd find the obvious flaw in it. If there were such lake where the lotus flower population doubles every day then starting from a single flower on day 1, the total number of lotus flowers on the 50th day would be 562 trillion and that would be more than the entire surface area of Earth.

Do you see how compounding stumps us again and again?

The simple looking equation of compound interest hides its enormity in just one thing. The unassuming 'n' — number of years. When n is large, it doesn't matter where you start — like the single grain of rice — you always end up with a bewildering sum.

Here's a simple illustration from my friend Vishal that captures the power of compounding beautifully.



Every time I look at my portfolio and discover a stock where the price movement hasn't yet caught on with the quality of earnings and the growth of the underlying business, I can hear the voice of impatience in my head telling me to sell the stock. And when I feel like giving in to that voice, the sanity prevails when I remind myself Munger's words on compounding —

"The first rule of compounding is to never interrupt it unnecessarily."

More than 2,000 books are dedicated to how Warren Buffett built his fortune, writes Morgan Housel, "But few pay enough attention to the simplest fact: Buffett's fortune isn't due to just being a good investor, but being a good investor since he was literally a child."

At the age of 55 years, Buffett was worth $1.4 billion. Today, at 88 years, his net worth is $90 billion. Which means, more than 98 percent of his net worth today has accumulated after he turned 55. The back-loaded nature of compounding isn't easy for the human brain to fathom.

Housel sums it up well —

"It is so easy to overlook how powerful it can be to take something small and hammer away at it, year after year, without stopping. Because it's easy to overlook, we miss the key ingredients of what caused big things to get big. How can most of Buffett's success be attributed to what he did as a teenager? It's so crazy, so counterintuitive. And since it's crazy and counterintuitive we overlook the right lessons. So we write 2,000 books on how Buffett sizes up management teams when the biggest and most practical takeaway from his success is, "Start investing when you're in third grade."

Start early, save consistently, invest wisely, and don't interrupt the compounding unnecessarily. If you can follow this advice for a long time, decades later when people ask you about the secret of your riches, you can probably tell them —

In the initial years, compounding tests your patience and in later years your bewilderment.

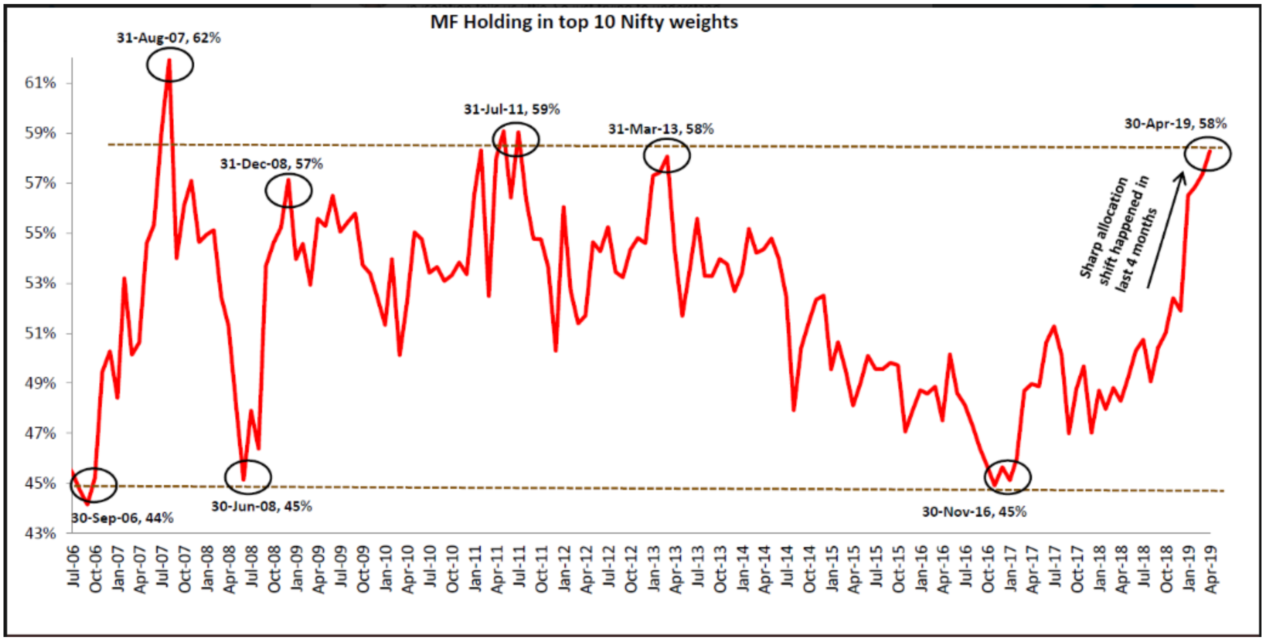
~End~

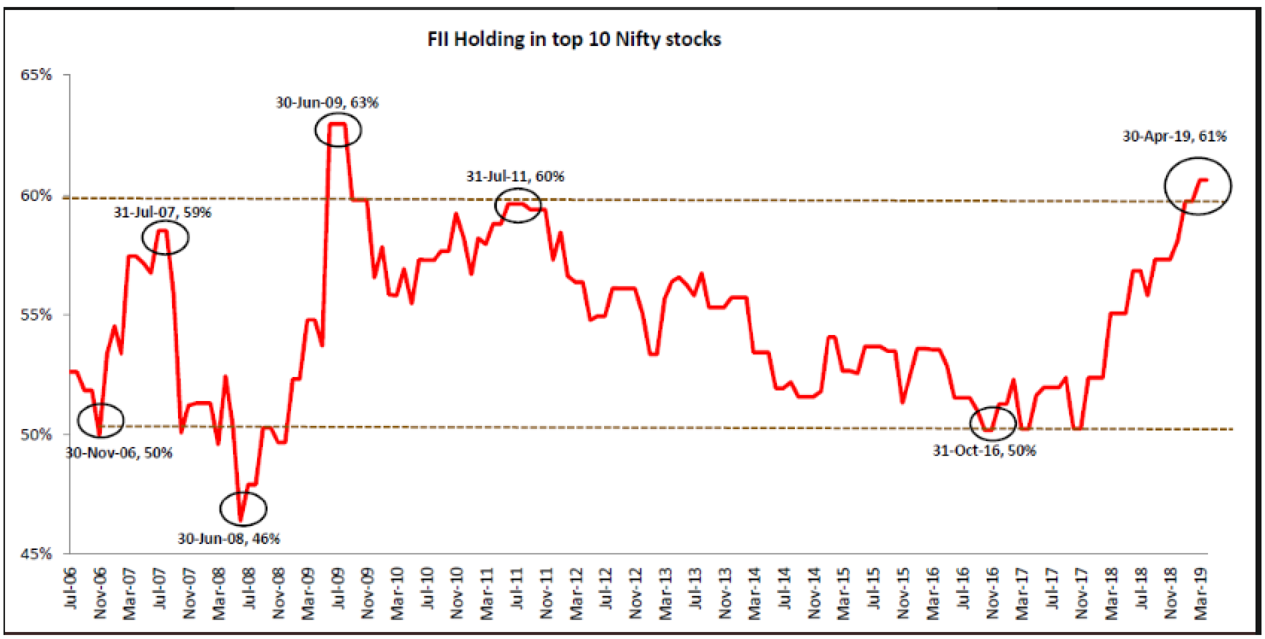
SMART SYNC INVESTMENT ADVISORY CELEBRATES ITS 2ND ANNIVERSARY

While I am writing this newsletter, Smart Sync Investment Advisory completes its 2 years of existence. We received our Investment Advisory certificate from SEBI on 20th June, 2017 and started advising clients on their portfolio from 1st August, 2017. We take this opportunity to thank all our esteemed clients for their continued patronage. The below table highlights our performance, for the period since inception, compared to the major indices of the Indian stock market

PERFORMANCE OF SSS AS AGAINST MAJOR INDICES (Starting from 01.08.2017)				
PARTICULARS	31.12.2017	31.12.2018	31.03.2019	30.06.2019
Nifty 50	4.11%	7.39%	14.92%	16.60%
S&P BSE Midcap	15.29%	-0.21%	0.09%	-4.20%
S&P BSE Smallcap	19.63%	-8.41%	-6.49%	-11.33%
SSIAS Model Portfolio	16.71%	4.53%	5.19%	-0.73%

Our SSIAS Model Portfolio performance does not appear good as on 30.06.2019. The year 2018 and the first part of 2019 has been one of the toughest periods in the Indian stock market history. While the NIFTY & Sensex continued their upward march helped by a handful of stocks, the broader market remained under severe pressure. If we see the table above, in the same period BSE Midcap and Smallcap Index have fallen by 4.2% and 11.33% respectively. In the last quarterly newsletter we spoke about the polarized performance of NIFTY/Sensex versus the midcap and the small cap universe. We want to further substantiate that claim through the following two charts.





Top 10 stocks in NIFTY are over-owned. Period.

How long will this rally last? We have no clue.

Are we going to join this rally? No way!

Instead, we will continue to focus on our process of analyzing individual businesses and buy ones which fall into our criteria. While we may have been wrong on a few ideas in the past, we are pretty confident of our overall portfolio construction. We strongly believe that if we continue to follow the process, the results will eventually follow.

SIGNING OFF

While concluding this edition of SSIAS quarterly, we would like to end with the same thoughts on which Anshul has written in the beginning on compounding:

In the initial years, compounding tests your patience and in later years your bewilderment

To believe in equity, one really has to think long term. We are lucky to have you as our long term partners in the same.

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About Us

We are a SEBI registered (INA000007881) Investment Adviser firm. We passionately believe that the people of our country must know about the importance of financial literacy and financial freedom and we will do everything possible to realize this vision.

We at Smart Sync Investment Advisory Services (SSIAS) are guided by the words of wisdom from the father of Investment Management, Benjamin Graham —

"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return."

We are aware of the prospects of exponential returns in the stock market, but we firmly believe that Return of Capital is more important than Return on Capital. Thus, while we look for avenues providing adequate return, we don't compromise on the protection of our clients' capital.

We intend to make all the relevant materials available on our website, free of cost. We would also write on matters involving finance and stock market investing. Any student of investment could derive a good value out of those blog posts.

Disclaimer

This report is for educational and discussion purposes only and is not a recommendation to buy or sell stocks. We may or may not have a position in the stocks discussed here. We may also change our stance on a particular stock at different points of time depending upon new development. Hence, for any investment decision, please contact a certified investment adviser.