The Joys of Compounding

Edelweiss MUTUAL FUND INSIGHTS

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Book Summary

In his book, 'The Joys of Compounding: The Passionate Pursuit of Lifelong Learning', Gautam Baid not only sheds light on the superiority of the value investing approach but also provides an intellectual toolkit for achieving an in-depth understanding of the world around us, including ourselves. He shares a holistic approach to investing that combines self-improvement, knowledge building, and investing wisdom. This is what makes the book markedly different from many other books written on investments.

Key takeaways

- Investment in self-improvement can help you improve your life and bring you success in your investments.
- In order to become a successful investor, you need to first understand human beings and human emotions.
- If you are humble about your knowledge, you will be better positioned to accept that you don't know everything. This will improve your learning journey.
- Basic arithmetic is enough to understand investing.
- You can improve your investing journey by maintaining an investment journal, creating a checklist, and investing for the long-term.
- By learning a little bit every day, you are compounding your knowledge. Similarly, by investing a little on a periodic basis, you will be able to compound your wealth.
- Time is your most important commodity. You must use it productively.

Self-Improvement and Worldly Wisdom

The best investment that you as an individual can make is an investment in self-improvement. This means that you need to focus on investing in your own intellectual and emotional development. An investment in self-improvement will not only make you a better investor and help you achieve your financial goals; it will also help you live a complete and full life. From that perspective, the first thing to do is to understand the high cost of wasting even a single hour. The opportunity cost of wasting even an hour can be exorbitant. On one hand, you can choose to be super active and multi-task by constantly addressing your emails and updating your social media feeds. On the other hand, you can dedicate your time to doing deep work and self-improvement. Spending even an hour each day in acquiring in-depth knowledge about an important principle can pay-off substantially in the long-run. This daily investment of an hour is minuscule compared to the significant net present value that results over a lifetime. It is the same thing as buying one dollar for less than one cent. This is why good books are the most undervalued asset class: the right knowledge and the right ideas can be worth millions, if not billions, over time.

If you adopt a purely quantitative approach and ignore human nature, then it is highly unlikely that you will succeed as an investor. This is because financial markets are like social constructs that are driven by human beings and as such, are subject to the entire range of human emotions. To attempt to understand financial markets without understanding human psychology and the fundamentals of mental models would be like trying to understand a hard science such as physics without first comprehending the underlying mathematics. Financial markets are more than numbers and equations. In order to truly understand the financial markets, you must first understand how human beings think and behave.

Humility and Good Karma

Do you need to be a good person with a sense of humility to succeed in business and investing? Honestly, there are so many examples of people with poor ethics who seem to do quite well in terms of building their net worth. Most of you probably know at least a few people in this category. If your only goal in life is to accumulate wealth, it would be naive to suggest that the only way you can improve your bank balance is by becoming a good human being. However, the value investing community at large seems to broadly reject the notion of pursuing wealth as the sole objective in life. Obviously, this does not mean that value investors do not pursue wealth creation. They most certainly do. However, they prefer to take a more enlightened approach when it comes to how wealth fits into a broader notion of a life well lived.

Efforts towards self-improvement and building a sustained good character can be highly worthwhile. Further, by observing the traits of people who constantly strive to improve, you can gather insights that can compound into great wealth. For example, the ability to be humble is a mindset that can allow you to be open to new ideas and opinions. Arrogance, on the other hand, can close your minds to alternate ways of seeing the world and can blind you to views that are divergent from your own best-loved ideas.

The deeper you dive into a field, the humbler you are likely to become. This is also known as the Dunning-Kruger effect. If you show intellectual humility and acknowledge that there are things you don't know then you put yourself in a better position to learn more. It is important to understand that true expert knowledge, whether in life or in investing, does not exist. The only thing that exists is varying degrees of ignorance. As an individual, and an investor, it is impossible for you to know everything. However, you can learn every day and work hard to become just about smart enough to make above-average decisions over time. That is the key to successful compounding.

People who approach life with a sense of humility and constantly seek to improve themselves through knowledge, are likely to find more opportunities for growth and success. Inarguably, there is no direct or tangible benefit of being generous with your time and insights. However, over a long lifetime, you have a much greater chance of good things happening to you through "luck" that really had less to do with luck than with good karma built up by being a decent human being.

Nuts and Bolts

At the end of the day, you cannot hope to succeed as an investor without understanding the field of investing. However, it is not sufficient just to understand the discipline. You also need to adopt a solid process and develop competence in several areas that are related to investing. These are the nuts and bolts of investing. The main thing to remember is that every investor is different. Every investor's investment journey is different as each individual brings to the game of investing a set of interests, varying backgrounds, and our unique temperament.

A successful approach to investing can be to use checklists to improve decision making, keep a journal to enhance self-reflection, and invest for the long-term to harness the power of compounding.

1. Maintain a checklist or investing journal: Because people are not rational animals but rather rationalizing animals, journaling offers can become an essential tool for self-awareness, self-reflection, and successful investing. The vast majority of investors do not keep a journal. It would be good to maintain a journal that contains the original investment thesis at the time of the stock's purchase as well as the rationale for the sale of the shares. A journal is the most objective way to remain true to principles and avoid hindsight bias. It also help you continuously learn from your mistakes. The insights gathered from such reflections can become your greatest learnings in life, business, and investing. These can benefit you throughout your lifespan.

2. Keep an eye on the past and invest for the long-term: Rather than reading forward looking statements by so-called financial experts, it is better to read more of financial history. Having a solid understanding of financial history is vital to developing the "nerves of steel" and avoiding emotional reactions during the inevitable periods of volatility and disruption. Studying history creates awareness of certain possibilities that would otherwise not be considered and facilitates a medium- and long-term, rather than a short-term, approach. Adopting a long-term perspective to investing is an essential element for becoming a successful investor. An example of maintaining a long-term perspective despite political noise is the strong performance of India's major stock market (Sensex) during 1984–2019, a period that witnessed nine different prime ministers or forms of government (majority versus minority). In India, a significant amount of uncertainty and apprehension surrounds government formation during election years. Throughout an electoral campaign, investors fear the market will drop precipitously if a coalition government comes to power. During the nine episodes examined between 1984-2019, the Sensex's compound annual growth rate (CAGR) was negative in only one case (–5.3% in 1996–1998). The other eight periods' positive CAGRs ranged from 4.0% in 1999–2004 to 48.6% in 1989–1991. The substantial interim stock price volatility had no material impact on either country's long-term equity market performance.

The Essence of Compounding

Different types of compounding exist in life. Understanding the exponential function that is at the heart of compounding is absolutely essential. However, it is equally important to acknowledge that similar functions exist in many other areas of life. If you compound positive thoughts, good health, good habits, knowledge, and goodwill, you will have enormous benefits in life that will go well beyond money. Additionally, the other effect of compounding in these areas can also lead to compounding wealth. Value investing, if viewed in this way, is more than an investing approach. It constitutes a lifestyle, a way of living that puts the odds in your favor and is also worth pursuing for non-monetary reasons. Compound knowledge building, just like compound interest, grows exponentially over time. It will allow you to draw on your own and others' instincts, judgments, and experiences. For example, reading just 25 pages per day equates to 9,000 pages per year, which would enable one to read Robert Caro's 1,336-page book The Power Broker nearly seven times in one year. Time, the currency of life, is a non-renewable resource that becomes increasingly scarce for everyone as each day passes.

Gautam Baid's book is a refreshing change from the usual investing books. It teaches us how to holistically embrace a lifestyle of self-improvement and knowledge enhancement. These two activities ll not only improve your health and life, but also your investing journey. Mutual funds can be an ideal companion for those who are looking to adopt a disciplined and long-term approach to investing. Mutual funds are basically an investment vehicle that allow you to invest in multiple investment instruments like debt, equity, and gold. Further, there are several mutual fund schemes that follow the value approach to investing, i.e., they buy stocks that can potentially generate strong future growth and are available at compelling valuations. Most of these are long-term in nature and can help you benefit from the power of compounding.