

Carlson, Ben – A Wealth of Common Sense

John Wiley & Sons, 2015, [Finance] Grade ★★★★★

Financial markets are immensely complex. They are not rocket science, they are much more complex than that since they incorporate feedback loops of people's ever changing and often irrational emotions. It's easy to think that to succeed in such an environment the strategy to use must be equally complex. Nothing could be more wrong. Complexity is best handled by the simplicity of a few rules. Ben Carlson who is a portfolio manager at Ritholtz Wealth Management and a successful financial blogger on asset allocation expands on the theme in this book. The target audiences are private investors and financial planners but there are insights for everyone.

A Wealth of Common Sense truly provides a wealth of important thoughts on investing and the author urges us all to have a plan for how to invest. "Without a plan volatility and uncertainty will eat you alive". In creating a plan it's important to realize that you have to take risk and endure pain to earn good long-term returns. In fact, the largest risk might be to not take enough risk to allow compounding effects over time – the author is clearly biased towards the stock market. At the same time there should be diversification since markets cannot be timed and most investors cannot endure the full effects of the crashes that come now and then. Diversification is an emotional hedge and allows rebalancing into cheaper assets.

A plan should be part of a system to automate productive behavior and long-term common sense. The plan should build on an investor's beliefs about the market, the investor must be able to understand it and its risks, it must suit the personality of the investor because if it doesn't it isn't practically feasible. If the plan isn't psychologically enduring in bad times it will be abandoned and it doesn't matter how good the plan was on paper, it will now instead be destroying significant value. As the author puts it "true risk is what is irreversible" - an abandoned

strategy risks locking in losses at the absolute worst possible time. While it might not be possible to time market crashes the investment plan should prepare for how any situation should be handled. Most will not be level headed without setting out a course of action prior to the chaos.

The subtitle to the book is *Why Simplicity Trumps Complexity in Any Investment Plan*. Given this the topic of simplicity vs. complexity in my view receives relatively little attention. Carlson rightly points to the huge incentives for complexity. Those who sell financial products can charge much higher fees for complex financial constructions than for simple ones. The buyers in turn feel smart and sophisticated when buying them, paying the fees. A quote from Nassim Taleb gets to illustrate the problem "The simpler, the better. Complications lead to multiplicative chains of unanticipated effects." When investing in complex financial constructions the investor will be trading volatility risks that will be passing, for a type of financial market functionality risk that unfortunately introduces a probability of making losses permanent.

The author's insights aren't really new and he has obvious intellectual mentors in for example John Bogle, Peter Bernstein and Charlie Ellis, but this doesn't make the thoughts less important and Carlson has a knack for catchy wordings that bring forward the theoretical and practical wisdom he has accumulated in a very effective way. For all the important insights I'd be glad to give the highest grade but in my meaning the book lacks direction. Some additional structure would have been needed for the reader to clearly see where the author is leading him.

The peddlers of complexity who live of the high fees they generate will claim that simple solutions like rebalancing to a 60/40 allocation or "buy and hold" strategies with regards to equity index portfolios have failed. This is simply not true, they have fared very well over time.

Mats Larsson, July 03, 2016