

Wednesday, June 13th, Monro by DAVE ROTTMAN

“There’s Always a Simpler Problem to Solve”

June 17th, 2018

To Focused Compounding members:

As a stock picker, when you’re first faced with the decision to buy or not buy a stock – it seems like a complicated question. Consider the mental math problem of 54 times 7. There are a couple ways of tackling this problem. The simplest though is to multiply 50 by 7, getting 350 and then multiply 4 by 7 getting 28. You add 350 to 28 and get 378. There are several ways of solving this problem. However, in actual practice, the method I laid out is the best. Sure, the answer is exactly the same as if you first multiplied 7 by 4 getting 28 to start. However, if your brain hits a snag while keeping track of the problem you’re solving you would, in the first case, already have the number 350 and therefore be just 7.5% below your target even if you gave up right then. Using the second method, your first step would only get you to the number 28. You’d be 92.5% below your target at that point and the only other bit of information you’d have is that the answer “ends in 8”. Knowing an answer ends in 8 might be useful on a math multiple choice test – but not much else. However, being just 7.5% shy of of an answer – and knowing you’re below the answer, not above – is often helpful in real life. The step “50 times 7” is simple and informative. The step “4 times 7” is just as simple, but far less informative. When analyzing something, the step you want to take next is the one that maximizes both the simplicity of the step and the value of the information you get by performing that step.

I said “...*the only other bit of information you have...*” back there. And that might be a helpful way to think of solving stock analysis problems: as taking steps that get you “bits” of information. What bit of information is most valuable to me? At the end of the day, a stock picker needs to decide only two things about a stock: 1) buy or don’t buy and 2) how much to buy. How much of your portfolio to put into a stock is an incredibly complex problem. A simple rule like always putting the same amount of your portfolio into every stock you buy can set that complex problem aside while you try to solve a simpler problem. Even then, you’re left with the complex problem of trying to guess what compound annual return this stock will provide should you buy it. How can you simply this problem? Well, you can take a problem that requires a quantity as the answer and turn it into one that requires only a greater than or not greater than answer. At any point in time, your portfolio will already have stocks in it. Assume you have no cash. You want to buy a stock. When you find a stock to analyze, is it really necessary to calculate the annual return you expect from this opportunity? Or do you just need to know the expected return on the stock you’re researching is better than the expected return on each and every stock you already own? Thinking that second way gives you a series of “is the expected return on this stock greater than the expected return on that stock” problems. However, that series of problems can be simplified to just a single problem. First, always keep the stocks you own ranked from best to worst in terms of the compound return you expect from here on out. Then, the only problem is comparing the expected return on the stock you’re researching now with the last place stock in your portfolio. It becomes a marginal problem. You only need to compare your least favorite stock you do own with your most favorite stock you don’t own. The question is no longer will Apple return 5%, 10%, 15%, or 20% a year. The question is now will Apple outperform Wells Fargo. That’s a much simpler problem to solve.

A handwritten signature in black ink, reading "Geoffrey Hunter". The signature is written in a cursive, flowing style with large, connected letters.