Quarterly Update Letter to Investors

September 2020

Dentists and Investors

Or

How often should you check your portfolio?

The pain of losing something is twice as powerful as the pleasure of gaining

Loss Aversion - Amos Tversky and Daniel Kahneman

I don't know what it is about writers, investors and dentists but whenever it comes to depicting a typical well educated investor, doctors and in particular dentists seem to be a favourite trope.

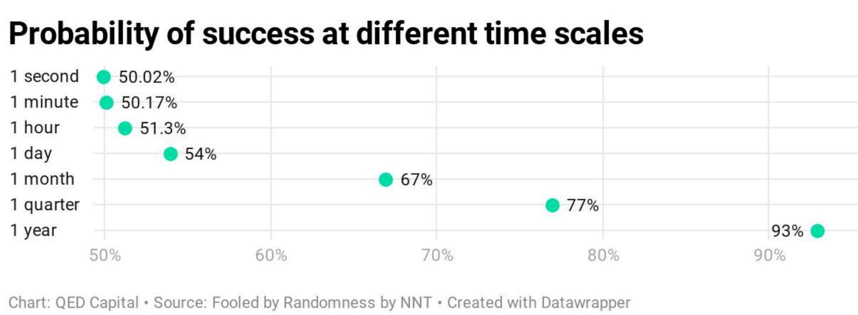
"When Patterson came to him, curious about the source of the money they were raking in, Laufer pointed to a different set of traders infamous for both their excessive trading and overconfidence when it came to predicting the direction of the market. "It's a lot of dentists," Laufer said."[1] Laufer and Patterson were Jim Simon's early collaborators at Renaissance Technologies.

In his book, Fooled By Randomness, Nassim Nicholas Taleb (NNT) tell us about a retired dentist who is also an excellent investor. Following is an extract from the book

"Let us manufacture a happily retired dentist, living in a pleasant, sunny town. We know a priori that he is an excellent investor, and that he will be expected to earn a return of 15% in excess of Treasury bills, with a 10% error rate per annum (what we call volatility).

Clearly, we are dealing with a very optimistic situation. The dentist builds for himself a nice trading desk in his attic, aiming to spend every business day there watching the market, while sipping decaffeinated cappuccino. He has an adventurous temperament, so he finds this activity more attractive than drilling the teeth of reluctant old Park Avenue ladies.

He subscribed to a web-based service that supplies him with continuous prices, now to be obtained for a fraction of what he pays for his coffee. He puts his inventory of securities in his spreadsheet and can thus instantaneously monitor the value of his speculative portfolio. We are living in the era of connectivity.

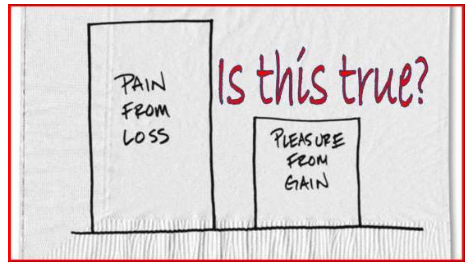


A 15% return with a 10% volatility (or uncertainty) per annum translates into a 93% probability of making money in any given year. But seen at a narrow time scale, this translates into a mere 50.02% probability of making money over any given second as shown below. Over the very narrow time increment, the observation will reveal close to nothing. **Yet the dentist's heart will not tell him that. Being**

[1] Zuckerman, Gregory. The Man Who Solved the Market

emotional, he feels a pang with every loss, as it shows in red on his screen. He feels some pleasure when the performance is positive, but not in equivalent amount as the pain experienced when the performance is negative.

At the end of every day the dentist will be emotionally drained. A minute-by-minute examination of his performance means that each day (assuming eight hours per day) he will have 241 pleasurable minutes against 239 unpleasurable ones. **Now realize that if the unpleasurable minute is worse in reverse pleasure than the pleasurable minute is in pleasure terms, then the dentist incurs a large emotional pleasure deficit when examining his performance at a high frequency.**



Consider the situation where the dentist examines his portfolio only upon receiving the monthly account from the brokerage house. As 67% of his months will be positive, he incurs only four pangs of pain per annum and eight uplifting experiences. **This is the same dentist following the same strategy**. Now consider the dentist looking at his performance only every year. Over the next 20 years that he is expected to live, he will experience 19 pleasant surprises for every unpleasant one!

This scaling property of randomness is generally misunderstood, even by professionals. I have seen Ph.D.s argue over a performance observed in a narrow time scale (meaningless by any standard).

A few conclusions:

1. Over a short time, increment, one observes the variability of the portfolio, not the returns. In other words, one sees the variance, little else. I always remind myself that what one observes is at best a combination of variance and returns, not just returns **(but my emotions do not care about what I tell myself**).
2. Our emotions are not designed to understand the point. The dentist did better when he dealt with monthly statements rather than more frequent ones. Perhaps it would be even better for him if he limited himself to yearly statements. (**If you think that you can control your emotions, think that some people also believe that they can control their heartbeat or hair growth.**)
3. **When I see an investor monitoring his portfolio with live prices on his cellular telephone or his handheld, I smile and smile**."

End of extract. Some technical portions have been redacted.

This extract assumes we are not in 2020, where everybody is a full-time investor and has a Zerodha/Robinhood account**. It makes sense therefore for non-full-time investors to do a thorough review of investment plans once a year and keep a check on their portfolios once a quarter**. However, from experience I know this is not close to the real world. Most investors check portfolios at least a few times a day because if they have access to it, then why not keep any eye on it while killing time during a commute or on the tread mill or while walking. This is because either they do not have a well thought out investment plan or they have taken more risk than is their risk tolerance or they just can't help themselves. **And then we wonder why investing is tough when all you need to do is buy low and sell high.**

AlphaBets

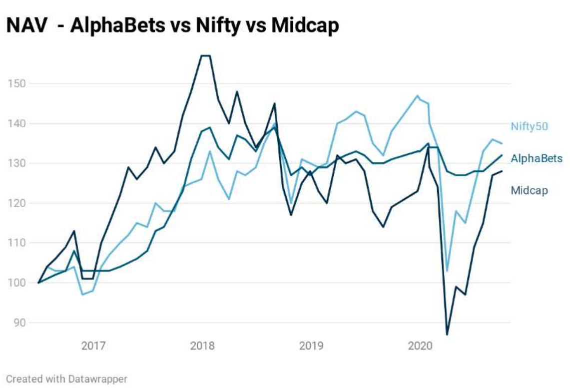
Markets are back to close to recovering from the March fall even though we have no sign of a vaccine or "flattening of the curve". However, daily life is slowly moving back to a semblance of regular activity. The new normal.

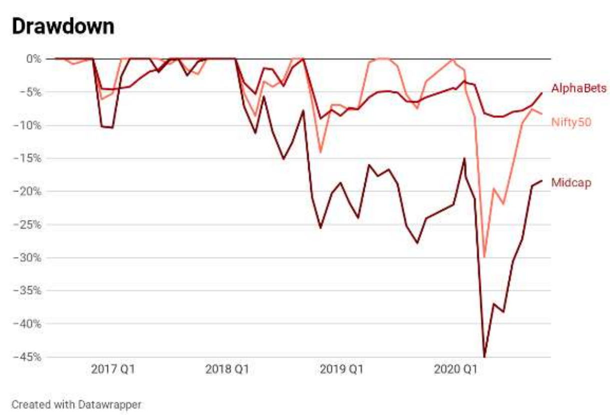
Nifty Midcap continues to trail AlphaBets. The portfolio is close to previous high watermark. Even though we are still not fully invested. We are adding equities at a steady regular pace. Going forward, we are going to perhaps see more volatility in the strategy as with the complete benefit of hindsight we feel today, we could have been more aggressive in upside capture at least as much as cautious we have been in protecting the downside. *So be prepared for higher volatility over the next couple of years.*

	AlphaBets*	Nifty 50	Nifty MidCap
Since Inception	6.7%	7.2%	6%
Max Drawdown	-9%	-29.9%	-45%
Sharpe Ratio	0.77	0.37	0.24

^CAGR Jul 2016 - Sep 2020 *Post Fees

The NAV chart below shows, the NAV since inception. Rs. 100 invested in AlphaBets would have grown to Rs. 132 (post fees and expenses), Rs. 135 in Nifty 50 index (pre fees) and Rs. 128 in Nifty Midcap index (pre fees). And while if one looks back at 3 and 6 month returns it may look like the index has delivered excellent returns, the chart below shows if one extends the period to 1y or 2 yrs, all that the index has done is bounce around violently, especially on the falls.





The **drawdown or the journey to get the above returns**, one would have been that from peak to trough one would have seen a maximum drawdown of <u>9% in AlphaBets, 30% in Nifty 50 and 45% in Nifty Midcap Index</u>.

Thank you for investing with us.

Stay safe.

Anish Teli and QED Capital Team

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