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Many investors are searching for theories to explain these uncertain times. While one would hope that these investors would search for simple, concrete explanations, unfortunately studies like the following from Professor Alex Bavelas (HT to Jim O'Shaughnessy of O'Shaughnessy Asset Management who posted it in a March 2019 Twitter thread) have found complex theories are generally more persuasive.[1]

The Bavelas experiment includes two subjects, 1 and 2, who are separated and told to identify healthy and sick cells on their projection screens using trial and error and then are told whether the guess was correct.

The interesting wrinkle in this experiment is that only the 1s gets accurate feedback (if they are right, they are told they are right). The 2s, however, are unaware that the feedback they are receiving is unreliable. In fact, the feedback a 2 gets is actually based on a 1's results. So even if 2 is right, they may be told they are wrong if 1 guesses wrong and vice-versa.

As a result of this structure, 1 has a proper feedback loop to help evaluate healthy vs. sick cells. As a result, 1 is able to craft basic rules that are simple and clear and eventually achieved an 80% accuracy rate. 2 lacks this feedback loop and is forced to rationalize the random data and craft a pattern where none exists. As a result, the 2s created convoluted theories and guessed with an accuracy rate similar to pure chance.

The participants then met to discuss their theories on identifying healthy cells and were asked to rate the strength of each theory. What's fascinating is that the more complicated theory of the 2s was considered more persuasive by both parties. In fact, the more complex the made-up rules that 2s presented, the more impressed the 1s were while the 2s were rarely impressed by the 1s' simple but accurate theory. In subsequent trials, the 1s began incorporating the 2's complex theories and performed significantly worse than they had initially.[2]

Investors fall prey to similar biases. Complicated investment pitches with detailed financial models are often perceived as more compelling than simpler pitches based on "napkin math". However, it has been my experience that the simpler investment pitches generally outperform. I believe this is an important lesson to remember, especially during periods of high uncertainty.

During the pandemic, I have focused on simpler investment theses where I can find a real edge on the critical components. As a result, my "too hard" pile has grown larger as I have avoided the increasing portion of investment ideas that rely on a large portion of unknowable factors. While complexity may sound impressive when presented, I believe we will make money by remaining focused on simplicity.

[1] https://twitter.com/jposhaughnessy/status/1106623229173686272
[2] https://perceptionmanagers.org/2008/08/bavelas-experiment.html