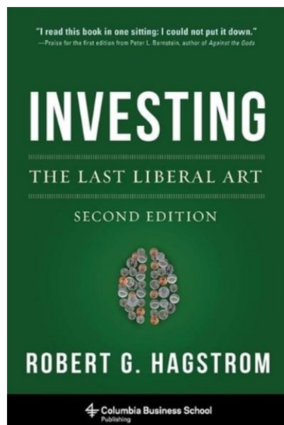

Title, Author: Investing the Last Liberal Art, Robert G. Hagstrom

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Liberal arts is a study of history, literature, writing, philosophy, sociology, psychology, creative arts and more. The objective of this book is to encourage investors to increase their knowledge of other disciplines in order to facilitate better decision making in all areas of life, including investing. The book takes inspiration from Charlie Munger's famous "latticework of mental models" concept, where Munger believes that, in order to make better decisions in business and in life, you must find and understand the core principles from all disciplines; learn all the big ideas and how they interrelate, and better, more rational thinking will naturally follow.

The book explains big ideas from the likes of Newton, Darwin and other great thinkers from complex disciplines – physics, biology, psychology, sociology, philosophy, literature and mathematics – and interrelates them with investment and the workings of the stock market to build a latticework that will help us better understand financial markets and eventually become more sound in our investing decisions. I would like to briefly highlight below the author's views, observations and findings for each of these disciplines which I have found very interesting and believe are apt while making investment decisions.

Physics; for more than two hundred years, economists have relied on equilibrium theory to explain the behaviour of economies. As per the author, if one would strictly interpret market equilibrium, there would be no booms or crashes, no high trading volume or high turnover ratios. But as we know all too well, trading volume and turnover ratios have continued to climb, and heightened volatility has become the norm rather than the exception. In much the same way, the balance between supply and demand, between price and value, will always be in evidence in the daily operation of the market, but it no longer gives us the full answer. Thus, the author believes that there are other forces which drive this so one must look to other mental models.

Biology; numerous traits of Charles Darwin's principles of evolution can be observed throughout the history of the stock market. The author looks at The S&P 500 Index and how it has evolved in a Darwinian manner, populating itself with stronger and stronger companies — survival of the fittest. Fifty years ago, the S&P 500 Index was dominated by manufacturing, energy, and utility companies. Today it is dominated by technology, health care, and financial companies. The author talks about how new trading strategies gained favour by overtaking a previously dominant strategy and was then itself eventually overtaken by a new strategy. Evolution takes place in the stock market via economic selection. Understanding financial markets in terms of evolution will give us a much better perspective to adapt to changes in the financial markets.

Psychology; investors are often unaware of their bad decisions. To fully understand the markets and investing, one has to understand our own irrationalities. Therefore the study of the psychology of misjudgement is every bit as valuable as the thoughtful analysis of a balance sheet. Possibly more so. The author believes, "the single greatest psychological obstacle that prevents investors more so for institutions from doing well in the stock market… is by tabulating losses on a frequent basis (myopic loss aversion). However overcoming this emotional burden penalizes all but a very few select individuals like Warren Buffet. He understands that so long as the economics of his companies continue to advance in a steady manner, the value of his investment will continue to march upward. He does not need the market's affirmation to convince him of this". As he often states, "I don't need a stock price to tell me what I already know about value."

Sociology; "I can calculate the movement of the heavenly bodies," said Sir Isaac Newton, "but not the madness of men". Sociology is the study of how people function in society, with the ultimate hope of

understanding group behaviour. When we stop to consider that all the participants in a market constitute a group, it is obvious that until we understand group behaviour, we can never fully understand why markets and economies behave as they do.

Philosophy; the true philosopher is filled with the passion to understand, a process that never ends. The author considers "Pragmatism is the perfect philosophy for building and using a latticework of mental models. For the pragmatist, the reliance is not on absolute standards and abstract ideals but rather on results — those things that are actually working and that help you reach your goals". Financial models have a tendency to work for a while and then unexpectedly stop working. A pragmatist will quickly realise this and will move on to a model which works.

Literature; Charlie Munger believes that to be able to create mental models we must educate ourselves. The key principles, the truly big ideas, are already written down, waiting for us to discover them and make them our own. The chapter talks about what to read, how, and why. For investors to broaden their horizons they must read for understanding, and not just reading to accumulate information. There is much to be learned not only from great works of literature but popular fiction as well; the author draws a parallel for his love of detective novels and his interest in investing. When investing, he is sceptical and looks to connect the dots. Both investing and being a detective are concerned with gathering clues (financial data) to determine whether or not the market is accurately pricing a security.

Mathematics: this chapter examines several mathematical concepts that are critical to smart investing. Regression is commonly used as a forecasting tool; it is a simple mathematical estimation that allows investors to predict the future. However, if this is so simple and effective, why is forecasting so difficult? Well, for one, reversion to the mean is not always instantaneous; overvaluation and undervaluation do not have a set time period in which they exist. In markets, the mean itself may be unstable; yesterday's mean might not be tomorrow's mean. The mean is capable of shifting to a new location, which tends to be a very difficult concept for investors to grasp. Looking at a current PE multiple and comparing it with the last 5 years' average to determine under or overvaluation may not always be the correct conclusion if done in isolation. If the business is stronger now than before then it may merit a higher valuation than past averages or vice versa.

The author concludes "One thing we have learned thus far is that our failures to explain are caused by our failures to describe. If we cannot accurately describe a phenomenon, it is fairly certain we will not be able to accurately explain it. The lesson we are taking away from this book is that the descriptions based solely on finance theories are not enough to explain the behaviour of markets. It is an incredibly imperative skill to think creatively and construct a latticework of mental models to think in multidisciplinary terms".

Reading this book has not only given me a good understanding of various complex disciplines but encouraged me to read more diverse subjects and built my own mental models to improve my decision making and become a better investor.

Shahil Shah
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