

THE ART OF IDENTIFYING AND AVOIDING MISTAKES

USING INVERSION AS A THINKING TOOL

CHARLIE Munger's inversion approach to investing is a mental model that involves thinking backwards and considering problems in reverse to avoid mistakes rather than seek success.

Munger, the long-time business partner of Warren Buffett, emphasised the power of inversion as a valuable thinking tool for decision-making, in including investing.

1. Understanding Inversion:

Inversion is a cognitive strategy that involves approaching problems by considering the opposite or thinking about negative outcomes. Munger believes avoiding the wrong decisions is more critical than making the right ones. Instead of focusing solely on what could go right with an investment, consider what could go wrong.

2. Munger's Famous Quote:

Munger famously said: "All I want to know is where I'm going to die, so I'll never go there."

That wisdom was inspired by Jacobi, the great Prussian mathematician, who said "Invert, always invert" could help solve difficult problems. Munger's quote encapsulates the essence of inversion. Rather than seeking success, he suggests identifying and avoiding pitfalls that could lead to failure. By doing the same, investors can enhance their chances of long-term success.



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3. Seeking Disconfirming Evidence:

In traditional decision-making, individuals often seek evidence that confirms their beliefs or decisions. Munger advises doing the opposite — actively seeking disconfirming evidence.

By looking for information that challenges your investment thesis, you avoid the trap of confirmation bias and make more informed decisions.

It is human nature to seek out and relish that which supports our investment choices and disregard that which goes against them. Scott Fitzgerald famously wrote: "The test of a first-rate intelligence is the ability to hold two opposing ideas in mind at the same time and still retain the ability to function".

4. Identifying 'Invertible' Aspects:

Munger encourages investors to identify the key variables and factors that could lead to the failure of an investment.

By understanding what can go wrong, you can take steps to mitigate risks and enhance the robustness of your investment strategy. This involves a thorough analysis of internal and external factors that may impact the investment.

5. Margin of Safety:

The concept of a margin of safety is closely aligned with Munger's inversion approach. Instead of relying on optimistic projections, he suggests building a margin of safety by considering the worst-case scenarios. This involves purchasing assets at a price significantly below their intrinsic value, providing a cushion against unforeseen adverse events.

6. Avoiding Permanent Loss of Capital:

Munger places high priority on avoiding permanent loss of capital. Inverting the perspective, this means focusing on how an investment can go wrong to prevent the irreversible erosion of wealth. By prioritising capital preservation, investors can increase the durability of their portfolios over the long term.

7. Understanding Second-Order Thinking:

Munger advocates thinking beyond the immediate and considering the second-order consequences of an investment decision. This involves analysing not only its direct impact, but also ripple effects. By adopting a broader per-

spective, investors can anticipate and navigate challenges more effectively.

8. Embracing Simplicity:

Inversion encourages simplicity in decision-making. Instead of getting entangled in complex financial models and speculative scenarios, Munger advises focusing on basic, essential factors that contribute to an investment's success or failure. Simplicity enhances clarity and reduces the likelihood of overlooking critical risks.

"Simplicity is the ultimate sophistication," according to Leonardo Da Vinci.

Often, we complicate things rather than simplify them. We assume sophistication equals results, brilliance, performance, and intelligence, but it doesn't.

More information, more choices, and more products is not better. It is the exact opposite. More is actually less and can cause your audience to disengage.

9. Learning from Mistakes:

Munger strongly emphasises learning from mistakes, both one's own and those of others.

By studying failures and understanding the factors that led to them, investors can gain valuable insights that contribute to better decision-making. Inversion involves actively seeking out and analysing past errors to avoid repeating them.

According to Henry Ford: "The

only real mistake is the one from which we learn nothing."

Embedded in every investment mistake is a lesson begging to be learnt. Human nature, however, does not relish mistakes, and they are dismissed with self-urgings that they be forgotten for the pain they inflict. Successes are celebrated with galore, and we often credit to ourselves successes which we do not deserve credit for.

10. Applying Inversion to Portfolio Management:

Beyond individual investments, Munger's inversion approach extends to portfolio management.

Investors should consider the potential risks and downsides associated with their overall portfolio strategy, asset allocation, and diversification. This holistic inversion perspective contributes to a more resilient and adaptive investment approach.

In conclusion, Munger's inversion approach to investing encourages a mindset that prioritises risk mitigation, capital preservation, and learning from mistakes. By systematically considering the inverse of a problem and focusing on avoiding pitfalls, investors can build more robust and durable portfolios in an unpredictable and dynamic market environment.

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