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RATIONAL REFLECTIONS

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Finding Confidence Amongst Uncertainty

- As rational beings, we know that the future is unknowable. But, as curious beings, we still have a yearning to know what lies ahead.
- In nearly every decision — whether it be investing, business, health, or relationships — there are some factors and inputs that we can predict and control, and others that we cannot.
- Getting comfortable with "I don't know" is a critical component of making better decisions.
- When we accept uncertainty in our lives, we are less likely to be trapped by seeing the world as only black or white when the most probable outcome is most likely some shade of grey.
- Life comes with no guarantees and few assured answers. And trouble likely comes to those who treat life decisions as having predictive or certain outcomes. Our mantra for clients is: Hope for the best but plan for the worst.

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After putting the kids to bed during this stay-at-home period, my wife and I have been taking a moment for ourselves by streaming James Bond reruns. We both marvel at the superhero's extraordinary attributes: brilliant intelligence, striking attractiveness, knowledge of languages and fine wine, persuasiveness, and emotional grace under pressure.

But in one key attribute, the fictional British Secret Service agent is notably superior to all others — his ability to make mostly effective decisions in the face of incomplete information and in the face of a near-endless stream of obstacles. He is so effective because he appears to be able to ferret out bad actors who strive for global domination and can quickly dispatch them. Based on past patterns and experience, he sees around corners. Unfortunately, the rest of us have to make do without the benefit of superpowers and Hollywood magic.

As rational beings, we know that the future is unknowable. But, as curious beings, we still have a yearning to know what lies ahead.

Daniel Kahneman, a psychologist and professor emeritus at Princeton University's Woodrow Wilson School and Nobel Prize-winning economist, has popularized the idea that we are tricked into believing that we understand the past, and because of that, the future should also be knowable. His point is that although we are good at logically interpreting the past, this does not translate into also being able to predict the future. Yet, we still seek the opinions of proclaimed experts as to what the future may hold: *Which track is the storm going to follow? Who is going to win the football game? What will happen to the stock market next?*

Analysts, like most people, tend to make forecasts about the future by extrapolating the recent past. Their predications for future levels of growth, inflation, and interest rates often resemble the current environment and levels. Behavioral economists refer to this tendency as "recency bias." These predictions end up being mostly right when markets do not dramatically change, which happens the majority of the time. **Occasionally, however, the future turns out to be dramatically different than the recent past. In these moments, the ability to make accurate forecasts become extremely valuable to investors.** But, paradoxically, it is also in these moments when forecasters are least likely to be right. So it begs the question: How valuable are the forecasts or opinions of proclaimed experts?

The Danish physicist Neils Bohr once said, "Prediction is very difficult, especially about the future." If you need proof, look back to any analyst's 2020 market outlook. How many correctly identified a global pandemic as a key risk? How many foresaw double-digit unemployment? Or that energy prices would trade at negative prices? I believe the answer is somewhere between zero and very few. Sure, there could have been one eagle-eyed pessimist who foresaw a sharp decline in equity markets. But was that forecaster able to square the circle by also foreseeing the incredible recovery since late-March? Highly unlikely. **As legendary investor Warren Buffett put it, "Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future."**

A few years ago, I decided that I no longer wanted be burdened with the daily scrum of live financial news channel in my office. I didn't need hours upon hours of pontification (usually with no accountability), the blinking lights and sound effects, nor the overly dramatized next 'Breaking News' story. It didn't make me a better portfolio manager nor advisor and I've never met anyone who had better results because they consumed more financial news. Therefore, I didn't want to support a financial news network or business model that didn't help me or my clients make better decisions. I also realized that one of the rarest phrases ever expressed on those channels is, **"I don't know."** And why would producers and sponsors of those programs ever encourage it? Nobody tunes in to hear a proclaimed expert admit to not having an answer. Furthermore, those admissions are seen as unhelpful, uninformed — even evasive.

It is difficult to comfortably live with the idea that we can only invest under the assumption that the future is mostly unknowable. Maybe this is a function of the way we, as a society, are taught to think. There is no place for *"I don't know"* on the test or quiz in the modern education system. A doctor cannot provide the diagnosis of *"I'm not sure."* And lawyers cannot argue on the basis of *"It's difficult to say."*

In nearly every decision — whether it be investing, business, health, or relationships — there are some factors and inputs that we can predict and control, and others that we cannot. These decisions, while only completely clear in hindsight, can be difficult in the present as they involve uncertainty, risk, contradictory or incomplete information, and sometimes wilful deception.

When we make critical decisions in our lives, we base them on a combination of facts and circumstances, prior patterns of decisions, and psychological biases that may have been hard-wired in our behavior since childhood. These decisions are uniquely our own, and we must live with the consequences. A Chief Investment Officer who writes a Market Perspectives piece may directly or indirectly influence our investment decision-making, but he or she doesn't have to live the outcome of what ultimately remains our decision. The financial pundit on cable financial news networks doesn't have to live with the outcome of our decisions, nor does our well-intentioned golf partner. Only we are the ones that have to live with our decisions. **Therefore, when we make critical decisions they should be unique to our needs and our circumstances — by which I mean time horizon, investment allocation, risk tolerance, cash flow needs, current health, etc.** It's not that elections, crude oil prices, tariffs, and politics don't matter — of course they do. But these aren't the primary determinants of our outcomes. Rather it is our decisions (or failure to take action, which is itself a decision) that the primary determinants of our outcomes.

As we think about the future, we should ask ourselves two questions: i) what might happen and ii) what is the probability that it may happen. If you're like Bond and have extraordinary skills, then you may be extremely confident in the outcome of your decisions. In those situations, considerations of risk are of lesser importance and you should act with little to no regard to fear. On the other hand, if you are unsure of the future, then deploying sensible risk-mitigation techniques — such as diversification, hedging, and holding highly-rated fixed income investments — may help guard against a wide range of potentially negative future outcomes.

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If we only see the world of investing as extremely optimistic (bullish) or extremely pessimistic (bearish), with no in between, then we limit our ability to make good decisions about how to best position our portfolios. **When we accept uncertainty in our lives, we are less likely to be trapped by seeing the world as only black or white when the most probable outcome is most likely some shade of grey.** Mark Twain summarizes this important point wonderfully, “It ain’t what you don’t know that gets you in trouble…It’s what you know for sure that just ain’t so.”

Life comes with no guarantees and few assured answers. And trouble likely comes to those who treat life decisions as having predictive or certain outcomes. **Our mantra for clients is: Hope for the best but plan for the worst.** This is especially true in today’s unknown and uncertain environment. We believe that by having an investment philosophy that is rational, process-driven, and guided by independent and unbiased thinking, we can all share the unapologetic confidence of 007.

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