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Mind Matters

An admission of ignorance: a humble approach to investing

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I fear that somewhere there exists a secret school (a Hogwarts for brokers and investment managers) whose first rule is that one should ever admit ignorance, and where any semblance of humility is surgically removed. However, if one can accept that you can't and don't know everything (or even very much at all) then a number of insights into investment start to flow. For instance it makes no sense to forecast, the margin of safety becomes central as a buffer against ignorance/error, market timing should be eschewed, and finally cheap insurance should be sought out. Humility should be central in the investment process.

- The general model adopted in finance seems to be that we need to learn more and more about less and less until we know everything about nothing. The fear is that if we don't follow this path we will end up learning less and less until we known nothing about everything. I respectfully disagree. Whilst ignorance may not be bliss, it a fact of life. As such we need to face up and deal with it. Embrace uncertainty, if you will.

- Once one has accepted that we cannot and do not know everything, then several investment insights start to flow. Firstly (and my pet subject) we shouldn't forecast. If the future is inherently unknowable, then forecasting is just a pastime, not something that deserves to be a central part of the investment process.

- The margin of safety becomes vitally important. Because we can't know the future, we need to protect ourselves from errors. This is, of course, exactly what having a large margin of safety helps ensure. Any given estimate of intrinsic value will only be correct by luck. As such, building in a cushion to acknowledge our limitations is vital.

- Market timing should be eschewed. Calling the ups and downs of markets in the short terms is next to impossible. Missing a few key days can have either a miraculous or a disastrous impact on your portfolio. This isn't the same as being fully invested at all points in time. One should steadily drip feed cash into the selected stock when Mr Market is having a depressed (as opposed to manic) period.

- Finally, one should seek out cheap insurance. Since we can't be sure what the future holds, cheap insurance makes sense. For instance, with the inflation/deflation debate raging, TIPs are a potentially cheap source of insurance with win/win characteristics, yielding 3%.

- Just for your information, this will be the last Mind Matters for a few weeks. I am taking a little time out to go and visit my family in New Zealand. Normal service will resume in a while, provided that my two nephews don't finish me off! In the meantime, keep well.

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An admission of ignorance: a humble approach to investing

It has long appeared to me that the first rule of finance often seems to be: don't admit ignorance. Perhaps there is some secret broker school (a twisted Hogwarts) that I managed to bypass where you are taught never to admit ignorance or fallibility, and where any sense of humility is surgically removed[1]. It should be noted that a fair number of buy-siders seem to have attended a master class or two at this mythical school.

Once upon long ago I attempted to study some philosophy. I must admit I don't find the subject easy as it often seems to disintegrate into little more than a battle of semantics. However, I found eastern philosophy easier to understand and less inclined to spend its time arguing over the meaning of words. Among the mass of wisdom that I came across there, two simple sayings managed to lodge in the Swiss cheese of my mind.

The first was Buddha's admonishment to his followers to "Doubt everything". This has formed one platform of my approach to thinking about investment over the years. It seems to me that we are far too keen to accept convenient theories and simplistic ideas without ever bothering to check their empirical foundation or validity. Investors might perhaps be better served by adopting a generally more sceptical standpoint.

The second was Confucius' observation that "To ask a question is but a moment's shame, but to live in ignorance is lifelong shame". In this spirit I have (never) shirked from asking questions even (or perhaps especially) when it was politically insensitive to do so. Of course, asking questions is an admission of ignorance, and thus frowned upon in our industry.

We have essentially created an industry in which everyone is expected to know more and more about less and less, until we end up knowing everything about nothing (the definition of a specialist). The prevailing view holds that if we don't follow this view we will end up knowing less and less about more and more, until we know nothing about everything.

However, I think humility is central to the investment process. Once one has accepted that you cannot and do not know everything (or even in fact very much at all), then a number of insights into investment start to follow.

Don't forecast

This is a subject I have often discussed (see Chapter 9 of Behavioural Investing and Mind Matters, 9 September 2008, link, for details and examples), but it is the most obvious manifestation of humility in investing. We simply don't know what the future holds, and frankly anyone who tells you anything different is either a liar or thinks you are a fool.

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[1] My wife, amongst others, will find it amusing that I am writing a note on humility. She regularly berates me for being arrogant. Now, of course, I reject this characterisation; but over the years I have come to appreciate that others' perceptions are often more accurate about the self than my own. However, regardless of the fact I may be arrogant, the way I approach investment puts humility at its very core.

Many investors seem to think it is impossible to invest without an explicit forecast. I disagree. I laid out the methods I use in Mind Matters (Op. Cit). Ben Graham noted that "*Analysis of the Future Should Be Penetrating Rather than Prophetic*."

He went on to give an example of a stock analysis which didn't require the kind of forecasting that is considered so integral to investing today:

> Example: Let us take the situation presented by Intertype Corporation in March-July 1939, when the stock was selling at $8 per share. This old, established company was one of the leaders in a relatively small industry (line-casting machines, etc., for the printing trade). Its recent earnings had not been favorable, nor did there seem to be any particular reason for optimistic expectations as to the near-term outlook. The analyst, however, could not fail to be impressed by the balance sheet, which showed net current assets available for the stock amounting to close to $20 per share… Certainly there is nothing attractive in this record, marked as it is by irregularity and the absence of a favorable trend. But although these facts would undoubtedly condemn the issue in the eyes of the speculator, the reasoning of the analyst might conceivably run along different lines. The essential question for him would be whether or not the company can be counted on to remain in business and to participate about as before in good times and bad. On this point consideration of the industry, the company's prominent position in it and the strong financial set-up would clearly suggest an affirmative answer. If this were granted, the analyst would then point out that the shares could be bought at 8 with very small chance of ultimate loss and with every indication that under the next set of favorable conditions the value of the stock would double. Note that in 3 years out of the past 5 and in 6 out of the past 10, the stock sold between 2 and 4 times the July 1939 price. This type of reasoning, it will be noted, lays emphasis not upon an accurate prediction of future trends but rather on reaching the general conclusion that the company will continue to do business pretty much as before. Wall Street is inclined to doubt that any such presumption may be applied to companies with an irregular trend.

There is nothing wrong with analysis. As Graham noted "Analysis connotes the careful study of available facts with the attempt to draw conclusions therefrom based on established principles and sound logic. It is part of the scientific method." So one can and should use analysis to guide investment, but forecasting should be abandoned.

As Graham opined "Forecasting security prices is not properly a part of security analysis". There is still considerable debate over this as I discovered at a recent meeting of our research department (which happened to coincidence with my two days in London in 8 weeks – talk about unlucky). I had the temerity to suggest that we should abandon target prices as meaningless (especially given current volatility) and was half-lynched by the analysts! As they say the road to hell is paved with good intentions[2].

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[2] Don't worry, fair reader, I am both big enough and ugly enough to withstand a good bashing from the analysts. After all they hardly escape scot-free on these pages!

Margin of safety is central

To require a margin of safety or a discount to estimated intrinsic value is nothing other than an admission of ignorance. No estimate of intrinsic value is ever going to be correct except via the intervention of good luck. Thus establishing a discount to this figure is giving a safety net for things to go wrong.

As I explored recently, value investing (the buying of cheap assets) contains an implicit margin of safety. The table below shows how value offers us protection against negative outcomes. It shows the performance of stocks based on their valuation and assumes perfect foresight on the earnings front. This allows us to examine the performance across value stocks depending on the earnings environment they end up facing.

By tracking across the first row we can see how value stock returns varied according to earnings performance. Strangely enough, the cheapest stocks that delivered the highest earnings growth generated the best returns. However, the protection of the margin of safety becomes clear as we move to the value stocks with the worst earnings growth — they still managed to generate pretty much a market level return.

In marked contrast, the glamour stocks (last line of the table) show the lack of protection inherent in buying stocks with high growth expectations embodied within their prices. The most expensive stocks that delivered the best earnings growth only managed to generate a return of around 8% p.a. on average (noticeably below the market return of 12% p.a.) However, this unimpressive performance pales into insignificance when compared to those high priced stocks that then go on to deliver the worst earnings growth; these stocks generated a return of little more than 2% p.a. on average.

Returns split by earnings performance (Developed mkts 1985-2007)

% per annum	Highest Growth	2	3	4	Lowest Growth
Value	19.8	21.6	17.7	15.9	11.9
2	20.6	18.0	13.7	11.0	10.9
3	17.8	14.0	11.6	9.87	8.10
4	15.7	10.5	8.55	6.67	6.12
Glamour	7.90	5.04	4.42	2.77	2.18

Source: SG Global Strategy

Eschew market timing

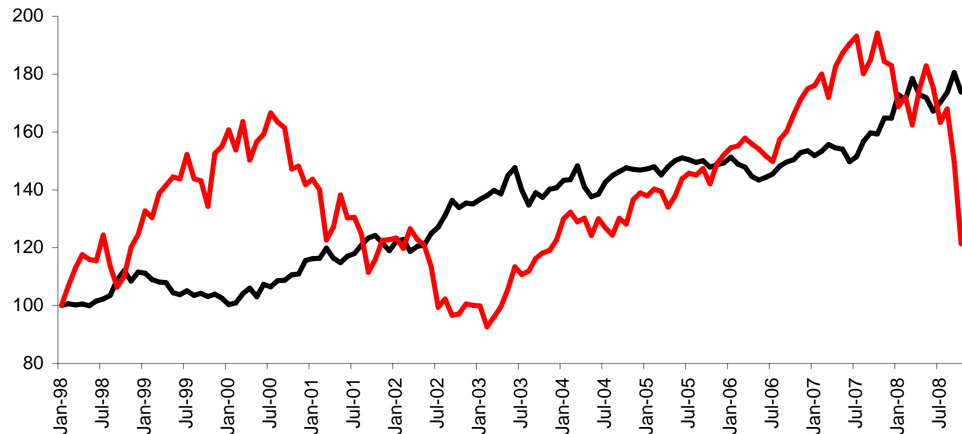
As Graham wrote “Most emphasis is laid in Wall Street upon the science, or art, or pastime, of prophesying the immediate action of the “general market”. However, if we can’t forecast then it would seem incredibly unlikely that we will able to call the bottom of the ‘general market’. As such we should eschew attempts to time the market.

This doesn’t mean that investors should always and everywhere be fully invested. As Seth Klarman has noted in the past, there is nothing wrong with holding cash if it is the result of an unsuccessful search for bottom-up bargains.

Indeed, a long-term investor can even take advantage of valuation signals from the overall market to make informed decisions (strategic asset allocation if you like). The last decade stands as a prime example. Over the last ten years, bonds have handsomely outperformed equities. Yet despite this when I present the top-down, long-run valuation picture it is often

ridiculed for keeping you out of the market for long periods of time. Guilty as charged and perfectly happy about it.

US 10 year bonds outperform US equities (1998=100)

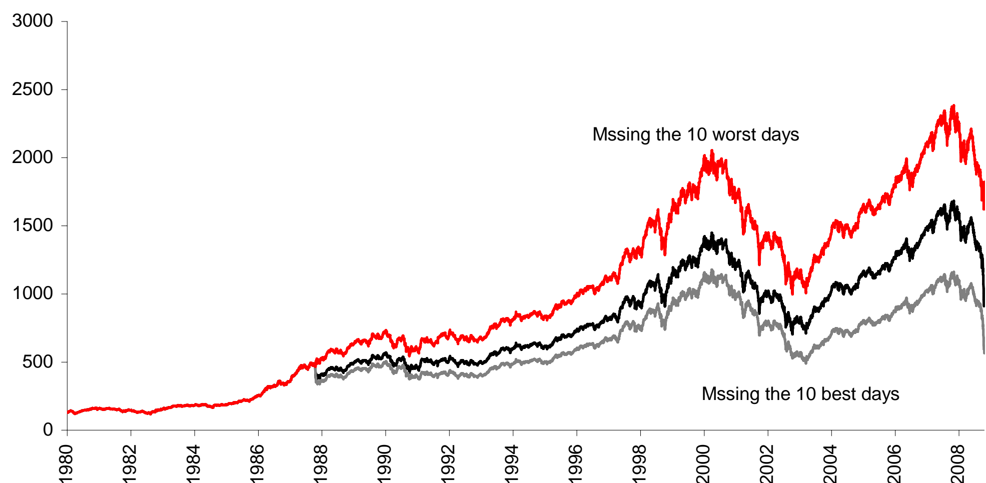


Source: SG Global Strategy

In general, market timers are not long-term investors. They try to call rallies and slumps of the market in the short term. This process is fraught with danger. The chart below shows the perils of this approach. It simply shows the performance of the MSCI World index since 1980. It also shows the performance if you had unfortunately missed the ten best days of the market, and the performance if you had miraculously managed to miss the ten worst days in the market.

The results are staggering. If you had missed the ten best days, you would have ended up with a return of less than half that achieved by a simple buy and hold strategy. In contrast, if you managed to avoid the ten worst days since 1980 you would have doubled the return from the market!

The perils of market timing – MSCI World Index



Source: SG Global Strategy

The bottom line is that market timing is arrogant and invites an expensive lesson in self-discovery. As Graham concluded "In market analysis there are no margins of safety; you are either right or wrong, and, if you are wrong, you lose money."

Rather than trying to time entry into the market, I would argue that a more humble method of investing is to build positions slowly over time. This is exactly what I recommend for our barbell deep value/cash strategy. Each time Mr Market is kind enough to generate bargains, I would deploy capital into them. Effectively, this amounts to drip feeding the cash into the market over time. Of course, if I knew the bottom was tomorrow I would be fully invested then. Similarly, if I knew the bottom was six months out I wouldn't deploy any capital until then. Of course, I can't know this so a slow but steady position build is yet another admission of ignorance.

Hunt for cheap insurance

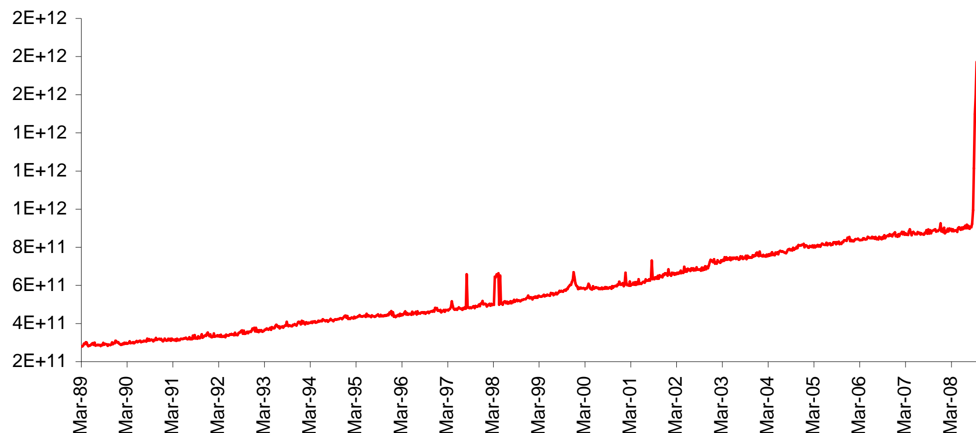
The final aspect of a humble approach to investing that I will discuss in this note concerns the hunt for cheap insurance. Since we can't know the future we can at least try and hedge out some of the uncertainties if we can locate cheap sources of insurance.

Perhaps the best way of explaining this is with reference to a current example. At the moment I am torn between the risks of inflation and deflation. Let me explain, I can clearly see the case for a large deflationary impulse generated by the bursting of one of the largest credit bubbles in history. In a world in which the US consumer is forced to abandon the debt-based Ponzi scheme which sustained the economy for years, the impact can only be deflationary.

However, I am also sure that the authorities will do absolutely anything to avoid deflation in a massively debt burdened economy. To wit, the Fed is taking just about every action it can (short of the outright purchase of US government bonds) to expand its balance sheet. My friend Albert Edwards has previously described this kind of process as Plan B.

As my colleague Paul Jackson pointed out in his recent Belgian Dentist missive, the size of the balance sheet has doubled in the last month, a process that more normally takes a decade!

The Fed's balance sheet

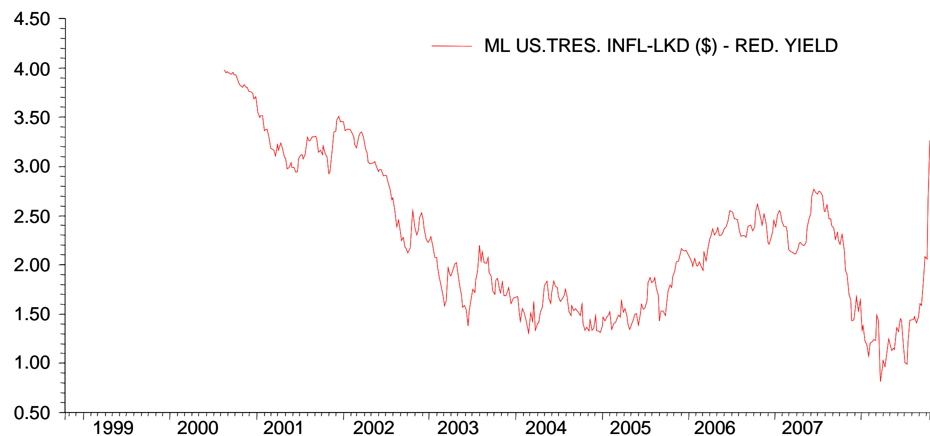


Source: SG Global Strategy

To my mind it isn't immediately clear whether this will create massive inflation. It would be for sure if the Fed was buying government bonds. However, I will leave to brighter people than me to pursue this and reach decision (there I go again admitting my ignorance! Writing this weekly isn't good for the ego).

Whilst I might not be able to solve the inflation/deflation conundrum, I can at least try to seek out some cheap hedges. TIPs spring to mind as an obvious winner. They are currently yielding 3% (real) - the highest I've seen for a while. Yet they provide an obvious hedge against the potentially high inflation. From memory (and it has been a very long time since I looked at these things) I think TIPs also offer a deflation floor (effectively you always get your full principal back in the event of deflation). Thus TIPs yielding 3% seem like a very attractive ignorance hedge.

TIPs yield



Source: SG Global Strategy, Source: Thomson Datastream

Whilst I am on the subject of things I know nothing about, the other potential inflation/deflation hedge is gold. Now, I have repeatedly argued that valuing commodities is very hard (since they are only really worth what someone else is willing to pay for them). However, I suspect that gold has attractive hedge properties. In the event of a loss of faith in fiat currencies (a standard outcome of inflation) then gold is the hard currency of choice. Secondly, should we get any closer to the end of capitalism and the complete shutdown of the financial markets, then gold again becomes a safe haven.

Conclusions: humility and investing

Ignorance may not be bliss but it is a fact of life. There is much we simply can't know. In the terrible language of the Bush administration both 'known unknowns and unknown unknowns".

Whilst the ever present behavioural pitfall of overconfidence beckons us to ruin like the siren song, a more humble approach to investing is possible and brings with it a safety first mentality.

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