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Things we can know and the futures we cannot

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KEY TAKE-AWAYS

- It is very difficult to make decisions in a complex world when you cannot know the future. Even when recognizing intellectually that predicting the future is impossible, people still crave certainty.
- You can approach decisions concerning the future probabilistically, and work to improve your odds of getting better outcomes, as investment managers do. This involves having specific attributes you are seeking in your outcome, and identifying the trade-offs involved.
- Constructing portfolios embedding the attributes that would do well in many possible futures requires a nuanced and insightful appreciation

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of risk. This approach means fighting your natural instincts to predict the future. At Prudential we aim to identify the plethora of possible outcomes that tomorrow might bring, and assess those outcomes in search of the mispriced opportunity.

Most people agree the future is uncertain, and trying to find precision in the world of tomorrow is near impossible. They agree you should approach decisions concerning the future probabilistically and work to improve your odds of better outcomes. They may even offer the truism that good decisions might yield unlucky results, while you might get a lucky break despite making a poor decision.

But most people don't seem to operate probabilistically in the real world; most people want certainty.

People want to know the future

Despite all intellectual claims to the contrary, people desperately crave knowledge of the future. Perhaps we're hardwired to view the world in a right or wrong paradigm because that's how we're judged.

If you said it would happen and it did, you're right.

If you said it would happen and it did not, you were wrong.

Mental processes recruited for decision-making appear to operate in a similarly clunky fashion. Ultimately, we're forced to decide in a black or white way; either to do something or not to do it, buy or don't buy a stock, invest or spend. Overlaying the outcomes we experience to the decisions we make reinforces the binary paradigm.

Although the decision-making process is hardly distinguishable from one event to the next, the conditions and circumstances under which we decide can vary widely. One way to think about decision-making in an uncertain world is to contrast the frequency of a decision against the range of outcomes that decision might yield: in other words, how often you make this decision versus what are the possibilities. The accompanying graph simplistically illustrates this in regard to common life decisions.

At one extreme, there are decisions we make repeatedly, such as getting a haircut or deciding what to order at your local deli. Often the recurring decisions are embedded in a stable or slow-moving micro-environment

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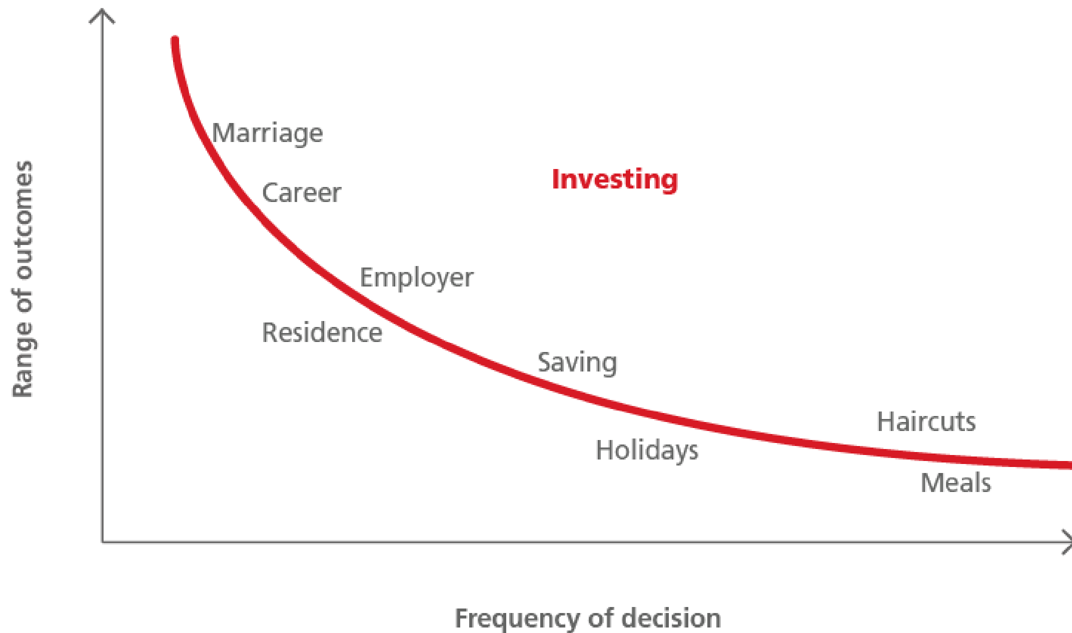
Graph 1: Decision-making in an uncertain world



SOURCE: Bloomberg

and have a fairly narrow range of outcomes (there is a whole separate discussion that can be had on the significant cumulative impact of small decisions, but we will leave that for another day). These decisions can be optimised for the best outcomes in time; if you did not like your previous haircut, you can get a different haircut (or hairdresser) the next time.

At the other end of the spectrum are the decisions we get to make very few times in our lives (sometimes only once), like deciding who to marry or choosing a career. Calibrating these novel decisions is more difficult since we lack reference points. Also, the outcomes of these decisions only become apparent in the fullness of time, leaving little opportunity to course-correct. They therefore embed a wide range of possible outcomes and are cloaked in degrees of complexity. Luck plays a much bigger role in how things turn out with these decisions.

Investment strategy is an endeavor that occupies a space somewhere between the extremes. Decisions

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around investments are made routinely, but the compounding nature of the endeavor leads to a wide range of possible outcomes - especially in actively managed portfolios. Also, being too skittish about an investment often robs the position of crucial time to take effect and add value, while a poor strategy left too long could result in a permanent and irredeemable loss of value. It's a balancing act that's difficult to optimise.

Seeking attributes

There's a natural limit to how much experience we can accumulate in novel or near-novel decisions; occasions to practice simply do not happen that often. And even with years of experience, investment decisions are fraught with risk because they deal with events in the future, and the world is a dynamic place (see recent events related to the global pandemic if you require further evidence that things can change suddenly and in unknowable ways). We can, however, hope to confront this uncertainty by seeking attributes.

Warren Buffett is famed for pointing out the attributes he seeks when evaluating investment opportunities:

- A business with a durable competitive advantage;
- Run by competent and trustworthy managers; and
- Trading at a reasonable valuation.

When Warren Buffett seeks companies meeting his exacting criteria, he's looking for investments that have a tendency to perform well over time. Spread over a number of stocks (i.e. in a portfolio), and provided the fullness of time, those attributes have the ability to manifest into something extraordinary.

"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."

— Charlie Munger

A corollary to improving your investment outcomes by prioritising attributes, is that companies with the right attributes also tend to stay out of trouble. This might seem a trite observation, but it is often missed in modern portfolio theory. Indeed, the Capital Asset Pricing Model (CAPM)

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statistically compares expected returns to stock risk (as measured by beta) – higher-beta stocks should outperform lower-beta stocks when the market return is positive. Alas, this simplification is myopic, often missing key attributes of better-performing investments through time.

Trade-offs

"A bird in hand is worth two in the bush"

– Medieval proverb

The above proverb has its origins in medieval falconry and refers to the idea that the bird in hand (presumably a falcon) was worth at least two birds in the bush (the prey). Although this phrase dates to the 17th century, there are earlier variants dating as far back as the first century AD. While simple in prose, the proverb succinctly highlights the idea of trade-offs. If you want the two in the bush, you must be willing to risk the bird in hand. There's also the nuance of how many birds in the bush should you be expecting?

Like the decisions we make, investment risk can often be seen through the lens of trade-offs. We assume risk in expectation of receiving something more in the future. We stand to lose if we are wrong, but gain if we are right – that is the trade-off. But the face value trade is only one part of the equation.

Concentrating your bets on a specific future produces fantastic results if that future comes to pass – in common judgement, you were right. It also produces very poor results if that future does not unfold. This is the black-and-white nature of outcomes. But there are shades of grey that we can explore to better manage risk beyond the simple black-and-white paradigm.

Constructing portfolios embedding the attributes that would do well in many possible futures requires a more nuanced and insightful appreciation of risk. It requires us to both view the future as probabilistic and behave in a manner that recognises this view. This approach means fighting your natural instincts to predict the future. A more insightful practice might be to identify the plethora of possible outcomes that tomorrow might bring, and assess those outcomes in search of the mispriced opportunity.

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This is not a simple task and not the way most people behave in the real world. At Prudential we try to embrace the idea of a probabilistic view of the world and follow a team-based approach incorporating a multitude of world views. We take a risk-conscious approach to portfolio construction, always seeking out the most attractive attributes against the risks. We remain ever-vigilant of the tendency to get lulled into expecting specific futures and constantly revisit our assumptions.

Most people agree the future is uncertain and that trying to find precision in the world of tomorrow is near impossible. We hope to practice what most people agree on. ■

With 14 years' investment experience, Aadil joined Prudential in July 2013 as an Equity Analyst. In August 2018 he joined a global equity hedge fund in London, before returning to Prudential in January 2020 as Head of Equity Research and joint-Portfolio Manager of the Prudential Equity Fund. He holds a BCom degree (Hons, cum laude) from the University of Pretoria and a Masters in Finance degree from INSEAD. He is also a CFA charterholder.

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