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PERITUS
Investment Consultancy

Mental models and uncertainty

Peritus Long Term Investing

We are great believers in the multidisciplinary approach introduced by Charlie Munger, who is best known for being the business partner of Warren Buffett. It has also been discussed by other thought leaders in the investment industry such as Michael Mauboussin and Robert Hagstrom.

The latter, who wrote an excellent book on this topic called *Investing: The Last Liberal Art* wrote that "from each discipline the thoughtful person draws significant mental models, the key ideas that combine to produce a cohesive understanding. Those who cultivate this broad view are well on their way to achieving worldly wisdom."[1] The disciplines from which some investors have tried to draw insights from include psychology, history, physics, philosophy and biology.

One example of the multidisciplinary approach that can be helpful in investing is looking at how bridges are built to handle excess weights as a mental model for margin of safety. This is about investing in stocks where the gap between the intrinsic value of the business and its stock price appears to be wide enough to make up for it not being possible to precisely determine the intrinsic value or potential mistakes in analysis and valuation. Another way to have a margin of safety could be holding some cash to ensure that one has the resiliency to weather the inevitable difficult periods during the investing journey.

We also like the sandpile model when thinking about market volatility and crashes. This involves imagining a pile of sand on which more grains are dropped in a constant stream. The pile keeps getting higher which reflects the stock market rising. The pile will eventually collapse, but it is impossible to precisely predict when this breaking point will be. Once the slide begins, it is also impossible to know when it will stop and how severe it will be. The impact is also non-linear as just one grain of sand in the end can cause the collapse of the entire sandpile.

This is similar to the stock market where large moves are often not caused by any significant news. In the sandpile model and stock markets it is often very difficult to know even with hindsight what exactly caused the fall. Therefore at Peritus we do not try to predict market crashes but instead focus on trying to find investments that we expect to do well over the next five to ten years and combine them with other asset classes and investment strategies that are not correlated.

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The other benefit of learning from different disciplines is that if the same patterns are observed over long time periods, it is more probable that these could be fundamental truths that are more likely to continue to last for a long time. Take for example the following passages from a book on military education, which refers to Leo Tolstoy's classic War and Peace:

Andrei "had long ago and often come to the conclusion during his military career that there is no such thing as war science and cannot exist, and therefore there can be no so-called war genius...".

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One could just replace the word "war" with "investing" and it would pretty closely reflect our experiences in the investment management industry where many try to make it appear overly scientific and try to look for market gurus who know what will happen in the future. The piece on military education continues with the following:

At the heart of the issue is the questioning that science could lead to full control of reality. Western thinking has been characterised by this belief in the ability of science. In the military sciences in particular, Tolstoy's criticism is timely as the words complexity, uncertainty and transformation have been of great importance since the late 1990s in the international military debate.

If Tolstoy, who is widely acknowledged as a great observer of human behaviour identified humans being uncomfortable with uncertainty and wanting to find experts that can control it with scientific methods over 150 years ago, it appears likely that these traits will continue to persist for at least another 150 years. This desire to control uncertainty and randomness appears to be universal across industries. It has been more successful in hard sciences like engineering or physics, and less so in areas like investing which also deal with complexity, uncertainty and transformation.

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Often investment processes are marketed as "robust", "rigorous" or some other word that tries to imply that it is scientific. This may involve sophisticated financial models, constant monitoring of portfolios or creating layers of statistics to measure everything, which can create the illusion of control when in reality it is not possible to really control risk in investment portfolios.

Because of this desire to avoid uncertainty there is great demand for market forecasts from experts, even though most investment professionals must know that these predictions are useless. At Peritus we accept that we must think in probabilities and learn to live with the unknown, no matter how uncomfortable it is. As Toiskallio and Makinen write:

…the U.S. Joint Vision 2020 document stated that the purpose is to prepare for an uncertain future, and the president of the University of the Marine Corps outlined that the basic mission of his institution is to "grow into a world of uncertainty."

It can be comforting to listen to someone who is confident and appears to be in control, when perhaps what investors need is to acknowledge that everything cannot be controlled and we must accept that some things are uncertain.

The basic idea of functional ability can be expressed by the idea of Kierkegaard, a philosopher… that there can be no ready path and way for the future, one can only have the courage to go towards the unknown.

'The key is to always remember that investing is about probabilities and accept that the future is unknown.'

The Peritus process does not rely on market forecasts apart from some very broad ones such as that equities can be expected to deliver positive returns over very long time periods. We also do not try to position client portfolios for very specific market outcomes but instead aim to build resilient accounts that are likely to deliver solid investment results in as many scenarios as possible while limiting catastrophic results in any of them. The key is to always remember that investing is about probabilities and accept that the future is unknown.

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Sources:

1 Robert G. Hagstrom, Investing: The Last Liberal Art (New York, Columbia Business School Publishing, 2000, 2)

2 Jarmo Toiskallio & Juha Mäkinen, Sotilaspedagogiikka: sotiluuden ja toimintakyvyn teoriaa ja käytäntöä (Helsinki, Maanpuolustuskorkeakoulu 2009)

3 Leo Tolstoy, War and Peace (1867)