THOUGHTS FOR THE WEEK

QUESTIONS RATHER THAN ANSWERS

September 16, 2022

Investors want answers. What will the economy do? What about interest rates, where are they headed? How will the stock market respond? Where will the S&P 500 be in a year?

Wall Street encourages this. Research reports are written authoritatively, forecasts offered with scant regard paid to the uncertainty surrounding said forecasts. The business channels are the worst offenders (in our view) - talking heads spouting predictions, quickly assigning "reasons" for why stock or bond prices did what they did that day, that hour, even that minute. There is as reason none of us have a TV in our respective home offices (most Wall Street offices still have TVs hung from the ceiling, as if a continuous CNBC scroll says "important work in progress here").

But as Howard Marks of Oaktree wrote in a recent FT editorial (link below), "To predict the path of the US economy, you have to forecast the behavior of hundreds of millions of consumers, plus millions of workers, producers, and intermediaries." Howard is writing of the fallacy of big predictions, using the economy as an example. We'll extrapolate further to add in the stock market, interest rates, and other "macro" issues. There are just too many variables to accurately gauge. And because the system is dynamic, each variable (we're in the trillions here) can affect other variables, altering *their* path – the variables are inter-dependent, but that interdependency is in constant flux. The definition of a complex adaptive system.

So rather than seeking answers, invert the problem and ask questions. Instead of guessing what interest rates will do, ask instead, "If interest rates rise to x%, what does that do to my borrowing costs? How might my bond investments be affected? How might my stock investments? Am I too dependent on low interest rates? Or can my investments / lifestyle survive / thrive in a variety of interest rate environments?" Flipping from answers to questions can illuminate vulnerabilities. You may discover you are too dependent on a narrow set of circumstances. Or that you're OK, financially, regardless of whether interest rates are x% or X%.

We do this in the research process. We spend less of our time forecasting what company A's sales, margins and earnings might be, and more time focusing on what is baked into the price today, and question, "What needs to happen for this investment to return x% / year over the next 5 years?" We may discover we only need to step over 1-foot hurdles for the investment to work (to borrow a Warren Buffett aphorism). Or we may find the investment requires Olympic medal level performance (a hurdle much higher than 1-foot).

Shifting from answers to questions is also valuable in the long-range planning process. Financial planning involves, among its many facets, incorporating long-term return forecasts. We know what those historical returns have been. But we don't know what they will be going forward. The distribution of returns is not limited, like that of a deck of cards. It's rather unlimited. We just don't know what the future holds.

So, the focus turns from what return is needed – the output which is not controllable (we can control *what* assets to invest in, but not the return *of* those assets) – to what layers of spending look like – a variable within one's control. We start with a base layer – what's the minimum level of spending needed to fit your lifestyle? Comparing that to the asset base supporting that spending, the odds of not running out of money start rounding into form. From there, additional levels of spending can be evaluated – call them levels of aspiration. Perspective changes from, "I need this level of return", to the question, "how might my margin of safety (chance of success) erode if I increase spending."

We're not suggesting forecasting is a waste of time. Perhaps the most valuable aspect of forecasting is having to come up with the inputs of the forecast. The exercise helps illuminates which variables are critical, and which are peripheral. Scenario planning is critical, forecasting not so much. And scenario planning begins with questions. So rather than trying to predict the future, invert the problem, and flip from answers to questions. You may find that the answers you're seeking – chiefly, "Am I going to be OK?" – become a bit clearer.

All the best,

Mike, Cate, Scott, Willis, Suzy, Oscar, and Westley

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Sources:
"The Illusion of Knowledge for Investors", Howard Marks writing in the Financial Times, September 9, 2022
The Illusion of Knowledge FT

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