

Don't Predict the Future—Seek a Margin of Safety

By Dan Erdle

Summary

This newsletter explores how to think about investing in a world where the future is inherently uncertain. The solution used by most investors, both amateur and professional, is to spend substantial time, money, and energy in an attempt to *predict* the future. My primary point in this memo is that the obsession in the investment industry with making forecasts about the future is not only futile but counterproductive as well. **As investors we would do better to admit the limits of our own knowledge and focus on those aspects of investing that we actually have substantial control over.** A second major point I hope to make is that the fact we don't know how the future will unfold does not mean all is lost. Luckily we don't have to be prophets to be successful investors. **The correct way to deal with this issue is to manage the risk of an uncertain future through discounted valuations.** Buying at cheap prices is the primary mechanism in which we can tilt the odds in our favor in the face of a potentially unfriendly future.

Why We Love Predictions

It is an odd perversion of human nature that we tend to focus our time, energy, and concern on all of the things we *can't* control. This is no less true in the field of investing. We have a desperate need to know how the economy is going to perform, what the Federal Reserve is going to do, what effect the current global headlines will have, and ultimately what the market is going to do next. When it comes to any of these topics everyone seems to have an opinion, many of them contradicting each other. I think there are a variety of reasons we as investors seem fixated on trying to predict the future:

- I think many people form opinions on these topics simply because they feel they have to. In order for people to gain respect of others and have people believe you are intelligent you have to come up with projections about what is going to occur.
- Investing using macro-economic predictions is fun. For many smart people it is intellectually stimulating to try to unravel the mystery that is the future. It offers people a chance to flex their intellectual muscle.
- In the investment world, self promotion and maintaining the image of an expert has become the most important thing. Simple answers don't bode well for an industry dependent on getting people to pay for access to their exclusive knowledge.
- Many professional investors begin to buy in to a certain line of thinking. They start to actually believe their own hype. Many professionals truly believe they are endowed with a special ability to tell you what is going to happen in the future.
- Making predictions about the future provides justification for our investment decisions. We simply *feel better* when we think our investments line up with a larger statement

about what is going to happen in the world. It gives us a sense of security to believe we have covered all of our bases by thinking about many moving parts.

- Compounding these problems is the major weakness of people in finance and economics who believe that because they are working with numbers that their efforts rise to the level of scientific or mathematical precision. Therefore they believe that by crunching enough numbers they will get a realistic account of the future.
- Finally, I think the root of the desire is the fact that it would be highly beneficial if we could know the future. Having a glimpse of the future would act as a silver bullet to most of our problems. I think it is the fact that we so desperately want to be able to predict the future that we delude ourselves in thinking we can do it. We simply want to believe it is possible.

Whatever the reason for the fixation on predicting the future, it tends to do nothing but lull us in to a false sense of security. We make predications, build complicated financial models, produce and consult numerous reports, and analyze economic data, all in an effort to feel assured we are making good investment decisions. As I will discuss later all of these efforts to feel better about our decisions are really quite useless.

Past, Present, and Future

“Don’t ever let yourself be fooled, and never forget that the easiest person to fool is yourself.”
-Richard Feynman

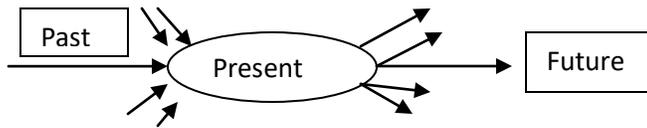
Out of all the variables present in investing, the one that we would most love to have information on—the future—is ironically the thing we know least about. How we deal with this dilemma is one of the most challenging aspects of investing. The accepted investment industry response has been that since *some single* future will unfold, all we have to do is figure out what it will be and our problems will be solved.

The problem lies in the fact that from the perspective of the present we should not view the future as a single course of events that will inevitably come to pass, but rather as a potentially infinite range of outcomes, albeit with some versions of the future more probable than others. Nassim Taleb’s concept of “alternative histories” from his book *Fooled by Randomness* speaks to this very important point. We tend to take life as it unfolds *as a given* without ever considering all of the alternatives that could have occurred instead. In hindsight, it always appears so obvious that things occurred the way they did. We then have a tendency to take this sense of obviousness and believe the future is a linear event that we can “figure out.”

The Way Most Investors View the World



Better Way of Conceptualizing Outcomes



Here we see a better way of thinking about the past and future from the perspective of the present. There is of course only one history that occurred, but we keep in mind all of the alternatives that could have occurred that we will never know about. Instead of accepting the course of events as a given, we humbly consider that things could have come to pass differently.

Looking to the future, we know that only one future will actually happen, but we understand it could take any number of paths. Instead of believing we can settle on the “right” one, we humbly acknowledge that there exists a range of likely outcomes and many more that we can’t even conceive of. We should consider that given the potential number of courses the future could take, whether we feel comfortable committing ourselves to one version of events.

The Paradox of Prediction

Let’s consider some of the difficulties that go into relying on forecasting as an investment strategy. The difficulty really occurs on two levels: 1) You have to accurately forecast what is going to happen in the world 2) Assuming you can accomplish the monumental task of an accurate prediction, you have to figure out how to act on that prediction. Not only do you have to be right once, you have to be right a second time as well.

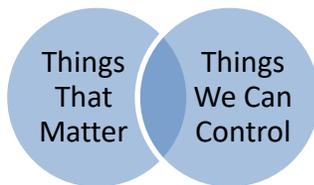
Let’s talk about the first difficulty—making an accurate forecast that will benefit you as an investor. The problem with forecasting is that in large part most forecasts by investors are just extrapolations of the current market trend. The paradox lies in the fact that the situation when a forecast would be most profitable would be one that accurately predicted *changes*. A simple extrapolation of the current situation is likely not to uncover large profits. When a person would really like to be able to predict the future would be at inflection points—identifying peaks and troughs. Unfortunately making these types of predictions are the situations when you are least likely to be correct. Rapid shifts in the economy and the market are rare, and they ironically come about when they are least easy to detect. If we could easily see them coming, they wouldn’t really be a problem would they?

So the times when we would find the most value in forecasts are also the times when they are least likely to be correct. In addition, because predicting large shifts require a bold bet, these forecasts are also the ones that have the highest costs of being wrong.

Now on to the second problem we have. Assuming we have a correct prediction, what do you do with our forecast? Even if we have a good forecast, we must figure out specific investment actions to take based on how we think the market will respond. Attempting to conceive how

the market will react to various events can sometimes be no better than a coin toss. A few examples demonstrate the difficulty in this area. Perhaps you predict that unemployment will go down in the future—what you think will be a positive, so you buy stocks. However, what if the market had priced in not only unemployment going down but at a better rate than actually occurs, and therefore stocks actually sell-off. Or what if you believe that a company is going to have a bad quarter, so you sell. If they have a bad quarter, but one not quite as bad as some had feared, buyers might come in and actually push the stock up. *So you can be right in your prediction and still be wrong on how asset prices move on account of that information.*

The Things We Can Control



Investing really comes down to three major things we can control:

1. What we decide to invest in.
2. In what quantity.
3. The price we are willing to pay in relation to our determined business value

Everything else that goes on in the investing world may be fun to talk about, but it is really only these three things that we can directly dictate. We must ensure that we don't neglect these three points—as these are all we have as investors. Don't sacrifice the few things we have control over for a whole bunch of things that are at best guesswork and certainly beyond our control.

How does this way of thinking help guide decision making?

Since I believe the future is essentially unpredictable, I want to prepare for a wide range of potential outcomes. For me the main aspect of the future that gets my attention is that **the future can be particularly unkind to an investor**. Most investors are preoccupied with determining all the great things that are going to happen with their investments. They build a case for all of the good things that will benefit their investment. For the most part, I don't think investors should spend their time thinking about all of the affirmatively desirable things that are going to go their way. The positives of the future will take care of themselves; I think investors can greatly improve their returns by acting on the assumption of the future not being good to their investments.

Instead of investing on the basis that positive things A, B, and C are going to happen, we should instead act on the basis that the future has it out for us. Approach it with the mindset that we

need to do as many things as we can to stack the deck in our favor. We shouldn't make an attempt to predict specific events or outcomes, instead we should prepare ourselves for a wide range of less than desirable future events.

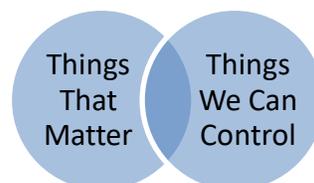
What is the primary way we prepare for a less than desirable future? **We use valuation as a way to discount the inherent dangers that exist in investing in the future.** By purchasing only at prices in which we feel we are being given a substantial discount, we subtly tip the odds in our favor. We don't have to know specific time and place events in the future if we have built enough safety into our price. By buying with a large margin of safety, we simply have to avoid doomsday type scenarios from occurring. And if we own several high quality businesses at a large margin of safety we increase the odds that as a group our portfolio will be able to withstand an unkind future.

There is also a practical aspect to avoiding predictions concerning the future. It is simply that I don't want to have to get up every day and *have to be right*. Getting a few things right every once in a while is difficult enough. It is almost impossible to be consistently correct on a question as difficult as to what the future holds. To force myself into a position in which my investment success depends on my version of the future coming to pass doesn't seem like a winning wager in my book. I would much rather assume the future is an uncertain place, and deal with it by ensuring that I am compensated for that uncertainty with a discounted valuation.

In most circumstances, by avoiding making decisions on the basis of a forecast of the future, we will focus on concrete things including:

- Favoring companies with high current cash flow.
- An assessment of the durability of business quality as the main determinant of what to invest in.
- Buying at a price well below our determined business value that can withstand a wide range of future events occurring.
- **Avoiding investments whose success are dependent on a specific future coming to pass.**

When thinking about the seemingly irresistible impulse in human nature to want to make decisions on the basis of a prediction about the future, it is always helpful to come back to this visual.



When assessing events that can happen in the future ask yourself two important questions.

Does this information matter?

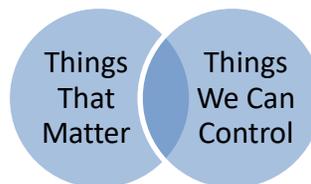
Certainly many of investor's favorite things to predict do in fact matter. Global political events, the health of the domestic economy, and Federal Reserve actions will have a major impact on our lives and our investments. Given this we move on to the second question.

Is this something I can control?

In the case of most macro-economic analysis and market forecasting the answer is no. For me, that's end of story. It may be difficult for most people to know that something matters, but not consider it in their investing. I on the other hand am comfortable with the fact that as an investor there are things that are important, but won't enter my investment decision making. I think successful investors come to the realization that many things are simply beyond their capabilities and that it is much better to focus your attention on the few things that you can get a good grasp on.

Conclusion

- Most investors believe that if something is important they must attempt to capture it in their decision making. **Intelligent investors are focused only on a small subset of things that are important—things they also have control over.**



- The things we have control over as investors are what we buy, in what quantity, and the valuation we are willing to pay.
- The future should not be viewed as events that are set in stone that are waiting for us to discover them. It is helpful to think about the future as an unknown variable that we must protect ourselves against.
- Don't make investments based on a certain version of the future coming to pass. If an investment is tied to affirmatively good things happening in the future, you are setting yourself up for difficulties.
- Investing becomes too difficult when you make your success dependent on your ability to continually be right.
- **If we purchase at discount prices, we don't have to predict specific outcomes or events.** We have prepared ourselves for a broad range of less than favorable outcomes.
- Positives in the future will take care of themselves. Focus your time on stacking the deck in your favor in light of the things that can go against you.