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BY RICHARD "JERRY" HAWORTH

Uncertainty Management

[i] *"Technology tends toward avoidance of risks by investors. Uncertainty is ruled out if possible. People generally prefer the predictable. Few recognize how destructive this can be, how it imposes severe limits on variability and thus makes whole populations fatally vulnerable to the shocking ways our universe can throw the dice."*

On a long flight to LA I had a weird thought.

In the real world, people hedge out uncertainty as a matter of course. Life insurance, director's indemnity insurance, car insurance, house and contents insurance, travel insurance etc. with nary a thought about it.

In the financial world, investors tend to ignore uncertainty and inevitably suffer the consequences. They are maybe willing to fail conventionally than to succeed unconventionally or, which is perhaps worse, willing to suffer the illusion of certainty and ascribe unknown risks to the known risk bucket which can be diversified away using the normal portfolio management tools.

[ii] *"The imagined suppression of uncertainty is nothing more than a mirage… The future is unknown, and we all constantly make assumptions. But to rely on assumptions as if they were certainty is irresponsible."*

Why is there such a glaring discrepancy in how we manage uncertainty in two distinct yet very important areas of our lives?

The most obvious answers are not that obvious…

The great leaps forward in portfolio management occurred before the existence of any financial product which could effectively do the job.

We are wired for optimism and have a blind spot to black swan risk.

In the real world, people are "coerced", normally by law, to manage their uncertainty. i.e., you cannot get a mortgage without house insurance. They probably would not get it if left to their own devices.

Uncertainty is what we know we do not know and therefore is unmeasurable. What is the correct price to pay for that? In the absence of premium efficacy, it is best left alone.

Investors unconsciously believe that the only way to reduce unknown risk is to get ahead as far as possible before the inevitable event happens i.e., prior event outperformance is your best bet.

The unknown risk is always manageable because the government or central bank will step in to bail asset prices out.

Perhaps it is like Titanic passengers, who, if they were offered a pre-booked seat on the lifeboats at a small premium, would disregard the idea as a waste of money as the ship is deemed unsinkable.

But the danger of ignoring uncertainty is real…

It lies not only in the fateful direction of your assets unfortunately, but also in the nature of time and volatility drag.

Any Nikkei 225 long term investor will attest to how much compounding possibility was lost over the long term by time elapsing. Such an investor would have been made whole (at last!) on his Nikkei investment made in the early 90's but would have lost 30 years of valuable compounding opportunities. The S&P 500 is up 17 times in the same period.

[iii] *"To survive and flourish in such a world, you will need a lot of mental flexibility and great reserves of emotional balance. You will have to repeatedly let go of some of what you know best, and feel at home with the unknown."*

Furthermore, an asset which reduces in price by 50% needs to make 100% to return to square one, hence the drag on performance.

Investors with less compounding time because of their age should pay even more attention to uncertainty, because they literally do not have the compounding time left, even if they wanted it.

Fortunately, there is a huge investable market where one can hedge out uncertainty at a price which, over a longer time frame, is additive to compounded returns.

Volatility assets … they thrive on a rise in uncertainty due to unforeseen events.

[iv] *"Sometimes the clouds weren't weightless. Sometimes their bellies got dark and full. It was life. It happened. It didn't mean it wasn't scary, or that I wasn't still afraid, but now I knew that as long as I was standing under it with Braden beside me when those clouds broke, I'd be alright. We'd get rained on together. Knowing Braden he'd have a big ass umbrella to shelter us from the worst of it. That there was an uncertain future I could handle."*

Disclosure

[i] "Heretics of Dune" by Frank Herbert.

[ii] "The Definitive Guide to Thriving on Disruption: Volume II - Essential Frameworks for Disruption and Uncertainty" by Roger Spitz and Lidia Zuin.

[iii] "21 Lessons for the 21st Century" by Yuval Noah Harari.

[iv] "On Dublin Street" by Samantha Young.