Investing with Uncertainty

We believe in making things simple. Like Einstein said, "Everything should be made as simple as possible, but not simpler." Our memos attempt to simplify difficult topics.

I believe two actions are responsible for a great amount of wealth destruction and the transfer of wealth from investors to financial sales and marketing firms (aka Wall Street): investor's obsession with certainty and avoidance of short-term losses and the myth that the future can be predicted with precision. We often get the question – how do you invest in an uncertain period of time like today? Concerns are real, including a bloated government balance sheet, high asset prices driven by seven years of zero-percent interest rates, quantitative easing and unsustainable stimulus spending, war, terrorism attacks, underemployment, slowing global economy, et cetera. Our answer: **we believe the future is and always has been uncertain.** People that wait for perfect certainty don't invest – they buy bank CDs. Curiously, the future tends to feel safer/more certain after long stretches of good times and less certain after bad stretches – but we know the opposite is true – extrapolating the most recent past is a common psychological error. We would argue certainty is a figment of our imagination. Since 1850, there have been 32 U.S. recessions[1] and since our founding in 1776 thru 2011, the U.S. was involved in a war in 214 of the 235 years (91% of the time)[2].

Investing is simply a bet on the future – we forego consumption today in exchange for more purchasing power in the future. But, given the uncertainty related to the future and many variables at play, how can one expect to profit from the future? Nassim Taleb is a professor and has authored popular books, including *Fooled By Randomness* and *The Black Swan.* He said, "Probability is not a mere computation of odds on the dice or more complicated variants; it is the acceptance of the lack of certainty in our knowledge and the development of methods for dealing with our ignorance." Our investment checklist (see the June 30, 2015 memo) is an example of a method to deal with our ignorance.

Most people and investors are uncomfortable with uncertainty and will do nearly anything to avoid it (generally doing anything that everyone agrees with in investing leads to misfortune). Many professional asset managers also share this discomfort while also believing predicting the future is the key to success – isn't that what investors pay for? We don't think so, in fact, we believe the future is largely unknowable/unpredictable, especially in the short-term. Any investment plan that requires the accurate heads/tails prediction of near-term future events will fail. So, you might ask, how do we build a long-term investment plan that will require the successful navigation of the future, without knowing the future?

Step 1: determine available investment options:

Investing is simple (but not easy) and astute investors must ask, what investments are available? We know of five buckets:

1. Business investments – public (stocks) or private businesses, private equity, venture capital, etc.
2. Real estate investments – commercial, residential, agricultural
3. Fixed income investments – bank deposits, money markets, corporate, municipal, mortgage, or government bonds, among many others
4. Commodity investments – gold, silver, oil, others
5. Currency investments – US dollars, euros, pounds, others

[1] Economic Bureau of Economic Research (NBER)
[2] http://www.loonwatch.com/2011/12/we-re-at-war-and-we-have-been-since-1776/

Five asset classes yet there are millions of investment choices, funds, firms, strategies, and a never-ending news cycle. There are more mutual funds than publicly-traded businesses in the U.S.[3] Why? Our imperfect answer: ingenuity of product marketing, conflicts of interest that incent people to create and sell "products" (aka commissions), the exploitation of the human search for certainty, and investor's willingness to attempt to predict the near-term. That's why people like annuities – because they're "guaranteed" (although we know nothing is guaranteed and investors pay a dear price to the insurance companies for that warm fuzzy feeling – for the record, we avoid annuities like the plague). We prefer direct ownership in businesses, bonds, and real estate, thus bypassing the middleman/product salesperson. Another point of confusion is tangible vs intangible assets. For example, some investors believe ownership in a local hotel or building is a tangible asset, while an investment in a common stock is intangible. We disagree – they're both tangible. Madison Square Garden is a public company that we own. MSG is just as tangible and our ownership just as real as ownership in the local Holiday Inn. Same goes for Hershey, Nestle, or General Electric. For some reason investors confuse their own proximity to an asset with tangibility. Form of ownership and location have nothing to do with tangibility – tangibility is determined by the underlying asset.

Step 2: allocate your assets:

Based on two hundred years of historical returns we believe business investments offer the most compelling long-term return potential and believe this trend is likely to continue for the foreseeable future. These assets allow investors to benefit from capitalism and the hard work and ingenuity of others, innovation, pricing power to offset inflation and have endured any and every calamity known to man. Real estate is also a good option – it is a good hedge to inflation and some real estate is in finite supply. Fixed income provides steady income streams but at the expense of a fixed upside and unlimited downside – this asset class is almost entirely driven by interest rates as bonds cannot innovate and raise prices, thus a lower allocation is warranted when rates are low. We would argue buckets #4 & #5 are more speculative than investment since they don't produce cash flow and thus cannot be valued (we determine value as the sum of future cash flows paid to an investor over his/her holding period). However, these assets can be worthy of investment in moments of maximum pessimism (e.g. energy today) and can provide a hedge to other assets.

There is a caveat: investing is a pari-mutuel system, like horseracing, meaning the prices and prospective returns (odds) are always changing based on the current price, so your "equilibrium" asset allocation should be altered periodically to reflect prospective returns. For example, we might define an equilibrium asset allocation for a client as depicted below. Notice, the current allocation is different from the target, reflecting the current environment and prospective returns per asset class, based on pricing today and expected returns.

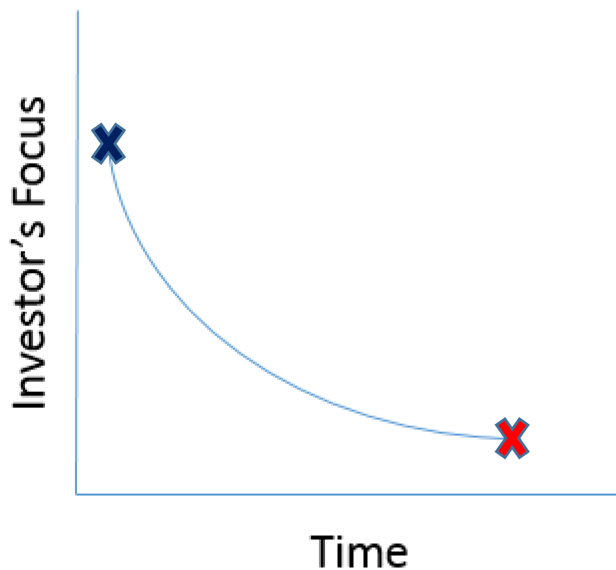
Asset Class	**Target Asset Allocation**	**Allowable Range**	**Current Allocation**
Business investments	70%	55-85%	55%
Real estate investments	10%	5-25%	10%
Fixed income investments	15%	10-30%	10%
Commodity investments	5%	0-10%	5%
Currency investments	0%	0-10%	0%
			remaining 20% in cash

Example Only

[3] http://money.usnews.com/money/personal-finance/mutual-funds/articles/2013/06/10/are-there-too-many-mutual-funds

Step 3: take a long-term approach:

The best investment strategy is doomed absent patience and discipline. All asset pricing, including businesses, real estate, or commodities are determined by anxious, emotional humans. Many times price and true intrinsic value vary significantly. The mere presence of marketability makes investors want to react to price movements (especially downward movements). For example, most of us don't buy a property and simultaneously tell the real estate broker to sell it if someone offers 30% below the current price – that would be irrational! But, when someone places a stop-loss trade[4] on a stock, it's the same logic – again irrational.



The diagram to the left is my attempt to artistically describe (I don't plan to quit my day job!) the focus of most investors. Not only are people obsessed with "knowing the future", but they also focus on a very short time horizon. As long-term investors our return will be earned over many years, often decades, not a single quarter. However, the news cycle, Wall Street, and even some perpetually-endowed non-profit institutions focus on near-term results and expectations. A long-term investment strategy should focus on the less crowded area (see red X) and avoid the hyper-active, crowded short-term space (see blue X). Also, as you lookout further, it's easier to reasonably forecast future returns based on historic metrics and reversion to the mean.

Step 4: require a margin of safety:

Given the many uncertainties and outlier variables, bad luck, and ignorance, a margin of safety should be required before making an investment.

Conclusion: uncertainty and risk cannot be avoided. I discussed risk in our 2013 letter and stated the greatest risk of all is the belief there is no risk (or that risk can be completely controlled). Risk and uncertainty are a fundamental part of life and your investment strategy should incorporate and manage them, not hide from them. Although we cannot predict the future, especially in the short-term, we can add value by tweaking our asset allocation, lowering exposure to expensive assets and increasing exposure to cheap assets. In periods like today when most assets are dear, we'll hold cash and short-term funds and be patient. We won't chase social media stocks and may underperform as we sit out of crowded, over-hyped assets, but when the pendulum swings back and long-term returns are more favorable (prices are lower), we'll raise the allocation to attractive assets accordingly.

I will focus on a history of asset bubbles and financial euphoria in our annual letter next month and will update you on performance and commentary around asset pricing. I look forward to talking to you then.

Merry Christmas!

Sincerely yours,

John

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[4] A stop-loss order is a trade order designed to sell a security if a specified price below the current level is met.