Verus

Sound Thinking

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Thinking skeptically

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Risk markets are currently trading at all-time highs, cryptocurrencies are soaring, and investment markets are looking forward to a broadly positive post-COVID future. At times like these it can be valuable to consider the role that skepticism plays in the investment process. How should an investor approach the wide range of opportunities that come across their desk, each presented by a convincing expert individual, but only a fraction of which are going to pay off? Answering this question requires us to focus on skepticism: skepticism about markets, skepticism about counterparties, skepticism about investment claims, and skepticism about models. Embedding skepticism into the investment process may help drive better decisions but understanding what that means can be hard. This short paper is designed to help clarify the role that skepticism can play, and also to clarify how investors can use it as a tool without being captured by it, because excessive skepticism may lead to missed opportunities.

What is skepticism?

A skeptical approach to investment recognizes the deep uncertainty of outcomes that we face, and that challenges each possible decision with a clear eye, trying to test the weaknesses of each approach. To make a decision we need to embrace the risks involved in that decision: skepticism is the tool we use to do that.

Skepticism and pessimism are different things. The point about skepticism is not that the investor should approach decision making with a negative perspective: that would bias the results of the decision-making process too much in one direction. Skepticism is inherently healthier: being open to the possibility of success, while understanding the possibilities of failure.

Skepticism and cynicism are also different things. A skeptical approach to investment claims made by providers is in fact a positive approach: being open to the possibility that there is an opportunity, and that the claims being made are well founded. A cynical approach, on the other hand, starts from a negative place, assuming that the opportunity being discussed does not exist, or that the person that is presenting it is being actively deceitful. This, cynical, approach is easy to fall into. After all, it is easy to find both failure and dishonest practices in any newspaper — but being overly negative in this way can lead investors to rule out real opportunities.

Skepticism, then, balances the reality that investment decisions are being made in an uncertain world and that ideas are being pitched by conflicted, profit-seeking individuals and firms, with the fact that opportunities do indeed exist, and that most participants in the investment industry are truly focused on trying to add value for their customers. Skepticism is the tool that allows realistic investors to be positive about the decisions they make.

Skepticism about markets

The first place where skepticism matters is investment markets. When looking at capital markets we need to be aware of three themes, and balance each of them against the other.

First, we have to start with the recognition that all of the major risk markets in which we invest have an associated positive expected return. Over the long term we expect an investment in these markets will usually increase in value[1]. We spend time focused on these long-term drivers in our Capital Market Assumptions. Long-term investors should remember that, although there are always tactical issues to be aware of, there is an expected long-term positive bias to the major risk markets.

That second theme is risk-awareness: markets are volatile, so there are regular periods where they go down — sometimes slowly, and sometimes rapidly. This is part of the longer-term positive performance, and while irregular these falls are not entirely random. It is also scary — we know that prospect theory from behavioral finance tells us that losses hurt more than gains feel good. Keeping a weather eye out for the possibility of an incipient downturn should be a core part of every investor's mindset and provides a useful fear-balance against the third theme.

That third theme is enthusiasm. Investors are social beings, and the marginal investor has a strong drive towards greedy excitement as we move further into a bull market. Enthusiastic bullishness and excitement will often be correct for quite some time — much longer than may make sense to the "rational" investor, and this can drive prices to levels that make no sense at the time (and that even prove in retrospect to be comical). This market irrationality can lead to the more rational investor suffering from the fear of missing out, which can drive them to investment decisions that they later regret.

Skepticism is the underlying tool that allows investors to play these three factors against each other, and this can be done in a relatively formal way, working through each of these three factors, and conducting a simple bull/bear analysis for each:

1. *Although we recognize there will be some periods where that is not the case*

— I know that the market is likely to provide me positive return over the long term. Some of that is likely to come from income that is reinvested, and some from capital growth. How much is due to come from each of these over the next short-term and long-term period? What could happen to cause this expectation to be wrong?

— I know that markets are volatile and that downturns happen regularly. What in current market conditions suggest that the next downturn might be deeper, or might actually represent a shift towards an intermediate term risk-off environment where I need to change my behavior?

— I know that the positive stories I hear about opportunities are often exaggerated, and that the more interesting they are the more likely they are to contain some exaggeration. Which of the positive stories and themes that I'm hearing are overblown? Which of them are simply short-term stories, and which of them have got longer term legs? What is being missed by the consensus investor because they are concentrating on these fashionable topics?

This approach anchors the investment conversation around three major themes that drive markets, allowing each of them to be an appropriate part of the decision making process, but at the same time making sure that none of them overpowers the others through excessive emotion.

Skepticism about counterparties

The second place where skepticism matters relates to counterparties. "What if" a counterparty in the value chain fails? How could that happen, and what would happen if they did?

This matters more than investors might want to recognize. I am in my early fifties and have been involved in the investment industry for just over thirty years. In that time there have been a range of counterparty issues, and potential counterparty issues, that have generated real world actual, or potential, issues for investors. While the most obvious example is that of Lehman Brothers during the 2008-2009 Global Financial Crisis, we can also look back at the failure of Barings Bank in the 1990s, the collapse of Long Term Capital Management, and many others.

Each example represents a unique set of circumstances, but there are also similarities. Markets act in odd ways, counterparties find themselves in sudden difficulties, and those difficulties cause actual or potential problems for other investors and for markets. Assets that should be safe suddenly feel much less so – assets that should be liquid become locked up and only available after years of litigation (if at all). Prices suddenly move in ways that make little sense, based not on rationality but on oddities of market structure and poor risk management practices.

None of these crises is ever exactly predictable. These events are both very rare and also inevitable. There is no way to prepare completely for the next crisis. However, a skeptical cast of mind helps ensure that at least a degree of crisis resilience is in place in advance – before the next problem occurs.

What does skepticism look like here? Asking what could go wrong. Which parts of the system are assumed "just to work", and what could cause those assumptions to fail? What reactions do you get from others when you ask these questions – have they thought about the issues involved, or are they simply assuming that nothing could go wrong? None of the answers you get from this process of skepticism will necessarily change what you do on a day-to-day basis. However, asking them and engaging with the answers you receive will teach you about the processes you are relying on to deliver portfolio outcomes, and will make you a more flexible investor when problems arise.

Skepticism about investment claims

The next place where skepticism matters is in the assessment of claims made by investment managers. Every investor is familiar with the problem: you could fill your day with an infinite series of meetings with investment managers. Each manager would be convincing, and would have a powerful story explaining why they will be successful over the next one, five and ten years. They will have powerful examples of good decisions made by the team, and one or two examples of "bad decisions" which will show off their risk management capabilities and will be delivered in a way that shows both learning and humility. And yet half (or more) of the products described in this compelling way are likely to end up underperforming the benchmark.

There is no immediate solution to this of course. The pay available in the investment industry means that some of the brightest minds of our generation are devoted to creating compelling stories around no more than adequate investment products. That merits two responses:1) a quick eye-roll about the state of the world, and 2) a series of probing questions, based upon skepticism around the truth-claims being made for each product. This needs to be balanced with a preparedness to believe that the product really is different: there is, in fact, genuinely good novel thinking out there, and it is important that investors listen to it with an open mind. But every claim should be probed and justified, and every idea weighed for credibility. Only a fraction of the ideas pitched will be truly worthwhile, so skepticism must be applied to every pitch. But that skepticism can lead to greater confidence in the ideas that make it past the assessment process. At Verus we have developed a manager assessment process based on a series of things we look for in managers – "the vowels". This list of topics of conversation (Alignment, Edge, Implementation, Optimal Use of Risk, Understandable Performance) help us focus on the areas that matter, and help us apply appropriate skepticism while still ensuring that we are able to treat truly interesting investment processes fairly.

Skepticism about models

Our final area of skepticism relates to models. Models are found all throughout the investment process, and each model is based on a series of assumptions about the world. Some of these assumptions are easy to spot and understand, while others are less so. Harder still is understanding the various ways a particular model will react to unexpected circumstances. The challenge we face is that models sound so convincing – and that they are so ubiquitous.

There are two good examples that quickly come to mind.

The first is the Sharpe Ratio: a very useful tool for describing the relationship between risk and return for an asset. While most investors know what it means, many forget the fact that this metric doesn't correct for asymmetry in the returns of asset classes – and that those asymmetrical behaviors are often what investors are looking for. The Sharpe Ratio remains a core investment tool, but remembering this underlying fact can help investors make better use of it, and can help them to understand when they might want to think more broadly about particular parts of the portfolio.

The second is the use of Capital Market Assumptions in typical optimization processes. Even the best forecast of returns is only an approximation of what might happen based on past experience and relationships. These forecasts give us a useful tool to estimate the future, but are no more than a guide to possible future outcomes. When used in a typical optimization the variability between expectation and reality that are a natural part of all forecasts can lead to odd outcomes, and to investors making decisions about the future that they may regret.

Applying skepticism in this area, as in other areas, involves asking questions. What are the assumptions baked into a particular model? What are the data sources? How do the assumptions one model is making gel with those other models make? What are the margins of error of the calculations involved? How can things go wrong? Asking these questions, and probing hard when the answers are unclear, will help the investor make sure they understand the tools being used to build their portfolio – and importantly how those tools can go wrong.

Conclusions

Investing involves few learnable superpowers, but skepticism may be one of them. Adopting a skeptical approach to the areas we have covered can help clarify the assumptions embedded in a portfolio, and help investors be sure their decisions and resources are well founded. Asking questions is the key to a skeptical approach, and a strong skeptical approach can both help investors identify weaknesses in their process and become more confident in the strengths. Skepticism is also at the heart of the consulting process: it is a practice we try to follow every day, and a skill we are constantly honing. There is uncertainty in investing; skepticism reduces areas of reasonable doubt to make the challenges we all face more manageable.

ABOUT THE AUTHOR

Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charterholder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is a member of the Audit / Finance Committee of The Medina Foundation in Seattle. He is also a member of the CFA Institute and the CFA Society of Seattle. Mr. Toner is a trustee of Charles Wright Academy, an independent co-educational school based in University Place, WA, where he also chairs the endowment committee. He is also a board member at the Seattle Metropolitan Chamber of Commerce, where he co-chairs the finance & audit committee. He has been happily married to his wife, Heather, for over 25 years, and is the proud father of two children.

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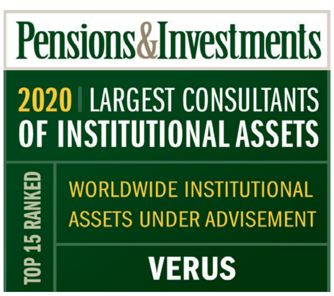

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