Weekly Commentary | November 7, 2014
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Betting on Red

If I were a betting person, I'd put all my chips on "Mr. Johnny Hockey" and the Calgary Flames. Yes, you read that correctly. The team has finally secured a talent that has significantly upped the ante. My forecast for the 2015 hockey year so far is very bullish, ending mid-year in a "C of Red", as the city ushers in the Stanley Cup.

We are inundated each day with similar far-reaching predictions, extrapolations, and trend lines as to where the economy is going. Currently, we are being led to believe it still has room to continue its ascent upwards, even after experiencing a recent blip in October. In a similar vein, we are often asked to provide our own predictions, as it relates to return expectations, interest rate direction, and where the Loonie will ultimately land. Below outlines why we avoid making such concrete predictions.

As Ned Davis Research recently highlighted, economists as a group have failed to call the last seven recessions. Not a good track record to base important financial decisions on. The problem is that forecasts are inherently fraught with overconfidence bias and are based on assumptions that are unable to factor in the unknown. It is difficult to alter one's assumptions for the unforeseen effects of the crisis in Ukraine, the resurgence of terrorism, the fast spread of the Ebola epidemic, or even what one of the harshest winters in recent history will bring. These aberrations become clear after the fact, but that doesn't help us today.

Now before I discount the value forecasting serves completely, let's look at how it can be useful. Howard Marks of Oaktree Capital states, "You can't predict; you can prepare." This is the essence of how QV utilizes forecasting in its security selection process. It helps us better understand the possible up-side and down-side outcomes of investing in a company. It helps shape our view on how the company will perform in various market cycles, and assists in determining the weight in which we hold the company in the portfolio. We are not as concerned with whether the forecasts we are hearing are right or wrong, but rather if we have prepared for either scenario, allowing us to maintain a margin of safety.

As it turns out, we humans are notoriously terrible predictors of our own future selves under emotional duress. This concept is otherwise known as an empathy gap. James Montier of GMO outlines this concept in his "Little Book of Behavioral Investing". A practical way of understanding this concept is arriving at the brunch buffet on an empty stomach. You fail to reconcile your future feelings of discomfort and guilt to your current emotional state as you guzzle down way more than your stomach can hold.

The above reference is nothing that a few hours on the treadmill and an afternoon siesta can't handle. Transpose this concept to your investment portfolio, and your appetite for return. Can you stomach the loss of capital that could arise in the future for the risk you were willing to take today to achieve higher returns?

It is not uncommon after a year of record performance, followed by softer returns, for FOMO to rear its ugly head. FOMO refers to the "fear of missing out," a concept highlighted in our weekly update from September 19th. It seems investors are more heavily influenced by their short-term views, which are tilted towards tactical movements engineered to eke out as much upside as possible, losing sight of their long-term investment objectives and the risk-taking required to earn those returns. Yes, due to our disciplined practice of investing, our results sometimes lag that of the broad market in the short-term, but it is also the very reason why we are able to protect capital and earn superior positive relative returns in the long-term.

I am a well-seasoned emotional time traveler. I know that I will be gravely disappointed if my Stanley Cup prediction does not come to fruition. Not to mention the shame I will feel amongst our resident Canucks and Oilers fans. However, it is not near the pain I would feel if I lost a significant amount of my capital due to one wrong prediction or assuming undue risk to generate returns. At QV, our disciplined practice helps to close that empathy gap.

Disclaimer: *The hockey allegiance expressed above is solely that of the author and does not reflect the personal views of all QV employees. QV's compliance department is not liable for any misplaced Stanley Cup bets.*