QV UPDATE

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The World is Difficult to Predict

While visiting Vancouver for client meetings this week, I was asked whether QV Investors forecasts macro trends. My quick answer was no, but it needs some explaining.

In "Thinking Fast and Slow", a book penned by Nobel Prize winning professor Daniel Kahneman, the psychology of judgment and decision making is studied. His book discusses research in which psychologist Phillip Tetlock interviewed 284 experts, who earn their living making economic and political forecasts. In the study, participants have to make predictions such as, would the US go to war in the Persian Gulf and would Mikhail Gorbachev be ousted in a coup? In total, the study collected 80,000 predictions over 20 years within and outside the participants' areas of expertise. The results were not inspiring. As it turned out, the experts' accuracy was even worse than if they flipped a coin. In fact, even those who specialized in a specific area didn't perform much better than those outside of their area of expertise. It was also found that the more confident the forecaster was in their predictions, the higher the probability they were wrong. Where the experts did add value; however, was in near term predictions.

Mr. Kahneman concluded that people will inevitably make errors in their predictions because the world is a complicated place. There are simply too many factors affecting an event's outcome to consistently make correct predictions. He also suggests those with the most confidence in their predictions should be watched carefully because they are most often wrong. As he states, "high subjective confidence is not to be trusted as an indicator of accuracy (low confidence could be more informative)." Rather, the forecaster who admits fallibility likely considers the potential outcomes more objectively. While a highly confident predictor often fails to fairly consider other outcomes despite their validity.

At QV, we would classify ourselves as predictors of low confidence when it comes to forecasting long-term economic or political trends. We recognize the challenge in predicting things such as the 10 year yield of Canadian government bonds at the end of 2017.

In recognizing the difficulty in consistently predicting the future, we focus our efforts on considering all possible outcomes. As an example, if we are analyzing an insurance company, we know its earnings will be greatly affected by changes in interest rates. In this instance, we consider a range of outcomes and what the most likely scenario may be. With low current yields, it seems more probable that five years down the road interest rates will be higher, but we will not give you a number. Regardless of our confidence in the strength of a business, we always ask what scenarios could knock our assumptions off the rails. We spend much more time analyzing specific companies rather than focusing on macro trends. We try to consider how certain macro trends will impact the company itself.

Inside the Fund – Ensign

Ensign Energy Services has been a holding in our large cap and balanced mandates since 2007. The last few years have not been easy for Ensign. When we wrote our initiation report in 2007, we did not predict the decline in shallow gas drilling and the current focus of North American drillers on deep and horizontal drilling.

However, today Ensign continues to have a strong and invested management team that has done a very good job of deploying capital. When we purchased this company there was no debt on the balance sheet – an attribute we are attracted to in a cyclical business. The balance sheet now stands at a debt to equity of 31% due to the number of rigs being built in order to transform Ensign's fleet to adjust its focus towards deeper basins.

In reviewing companies, we look for seven key characteristics that have been discussed in previous letters. By relying on these factors in the case of companies like Ensign, we have confidence that we don't have to perfectly guess the future environment. If we invest in strong firms, which can use their discipline and strong balance sheets to make the necessary changes in strategy, we don't have to make perfect predictions. The only prediction we know will be 100% correct is that our predictions will be wrong.