The Case for Non-Predictive Decision Making

Rob Campbell, CFA, Institutional Portfolio Manager
April 2023

MAWER

Be Boring. Make Money.™

The Case for Non-Predictive Decision Making

I have three children at home, and they are all obsessed with dinosaurs. "Dinosaur" is what my four-year-old answers when asked what he wants to be when he grows up.

Recently, I decided my oldest son—not the four-year-old!—was ready to watch *Jurassic Park*. It was everything I hoped for: wide-eyed wonder when first seeing the herd of majestic brachiosaurus and others brought to life on screen—made all the more stirring by John Williams' iconic score. (My son also handled the scene in which the venomous dilophosaurus kills Newman much more bravely than I did at his age…)

Rewatching *Jurassic Park* as an adult, especially in the wake of the various sequels, I couldn't help but wonder: why do the movies' characters continue to return to Isla Nublar? Aren't they aware of the risks?

The answer, of course, is that the characters believed they were smart or adept enough to anticipate the events or triggers that might lead to mortal peril. They believed they had designed systems and fail-safes that would keep the significant vulnerabilities at bay. (While all in some various pursuit of wealth or personal gain.) Many met predictable fates.

As an investment team, we've been thinking a lot about the mental model of triggers vs. vulnerabilities, especially given heightened market volatility and the end of the prolonged era of unusually low interest rates. The spectacular fall of Silicon Valley Bank seemingly happened overnight following a bank run. What was the trigger? Why mid-March 2023? Could the event itself have been predicted ex ante? And the more general questions as investors: where should we devote our time and attention, and how can we plan for triggers that are often ultimately unpredictable?

The Folly of Forecasting

In our view, market participants systematically *under*estimate the importance of vulnerabilities while correspondingly *over*estimating the importance of triggers. Why?

For one, triggers get more attention. The media tends to cover the collapse of the bridge, not the years of poor maintenance or decay that slowly reduces its structural integrity. For Silicon Valley Bank, the underlying vulnerabilities were present well ahead of time: a high proportion of uninsured deposits, a concentrated customer base, a duration mismatch, and both assets and liabilities that were sensitive to higher rates.

Second, human beings tend to have a natural bias to action. When facing penalty kicks, goalkeepers in soccer tend to guess where the shooter will kick the ball and dive accordingly, even though research has shown that they'd save more penalties by simply standing in the middle of the net. Likewise, we are naturally inclined to believe that forecasting triggers—e.g., will the Fed raise interest rates or not next month?—and taking action based on them is the best way to succeed in investing.

Non-Predictive Decision Making

Rather than anticipating triggers, a better approach in our view is non-predictive decision making: a focus on identifying vulnerabilities as opposed to forecasting specific outcomes. It is both more repeatable and more intellectually honest. In an uncertain world, there are any number of events that might influence the performance of a given investment; attempting to foretell all of them accurately isn't possible. This one-page memo, written in April 2001 by a Pentagon official for President George W. Bush in advance of a defense strategy summit, is one of the best arguments in favour of non-predictive decision making and a key mantra here at Mawer: "prepare, don't predict."

Non-predictive decision making encourages more flexible thinking, a longer-term orientation, and seeking fuller context, whereas a focus on triggers tends to narrow attention, frames of reference, and time horizons. To survive a walk through the jungles of Isla Nublar requires constant vigilance; being alert to the sound of any snapping twig. After all, danger is lurking around any corner. For the characters in Jurassic Park, the dangers turn out to be varied and not always obvious (a raptor in the dark)—power to the electrical fences fails, a torrential storm hinders Newman's escape, and the dinosaurs adapt unexpectedly.

It's well-understood that being in constant fight-or-flight drastically reduces the potential for rational and sound decision making. In such a state, when faced with new information, our (pardon the pun) lizard brains find it more difficult to distinguish between genuine signal and noise. Non-predictive decision making, then, is the arguably easier approach: no need to predict exactly what kind of disaster on Isla Nublar is waiting, or where or when it'll strike—just avoid the island entirely!

After all, as our Deputy CIO Christian Deckart often reminds our team, the trigger events themselves almost always serve as mere catalysts that expose existing vulnerabilities. The sharp rise in interest rates of the past year has had a profound impact on many businesses, but the underlying vulnerabilities were always there. Specifically, that the prolonged era of artificially low interest rates that preceded recent rate hikes caused certain companies to become overly reliant on steadily rising asset prices and easy access to cheap capital. These were not genuine nor sustainable business models and were destined to break at some point.

We are skeptical of businesses with high degrees of leverage for this very reason, but there are plenty of other general categories of vulnerabilities:

- Unprofitable companies that rely on continued access to capital markets to fund their operations
- Companies run by management teams with little skin in the game and/or poorly aligned incentives
- Businesses whose very existence depends heavily on the government's will to allow them to operate
- Enterprises that produce negative externalities for the environment or the communities in which they operate

To be sure, there are scenarios in which any company can be zeroed; even the strongest of businesses have vulnerabilities that can be exposed by the right trigger. But a "boring" focus on steering away from areas where those vulnerabilities are sharpest as opposed to forecasting triggers—even if it means sacrificing possible short-term gains—should lead to better and more consistent outcomes over time, and especially with appropriate diversification.

As Dr. Ian Malcolm says in Jurassic Park: "Life finds a way." Put differently, every vulnerability ultimately meets its trigger. Our advice? Prepare, don't predict.

Disclaimer

MAWER

Be Boring. Make Money.™