Why we Avoid Forecasts and Two Changes

Dear Fellow Investors,

Many different things that are happening simultaneously in the economic world are making investors, confused and worried. The world is buzzing with issues of logistics and shipping, lack of containers, energy scarcity, electricity blackouts, prices of every fuel source and metals, even shortage of long-distance truck drivers in the UK! That apart, many people are worried about possible reduction of liquidity and rising inflation and perhaps, a rise in interest rates. This is a lot of complex stuff to process but then this is not unusual. When has the financial world ever been calm as a placid lake? A few months ago there was the semiconductor shortage. Some other high-octane economic events may dominate discussions in the next quarter. How should we handle these complex, fast-developing and ever changing events? We have three points to make.

1. We don't know that we don't know

A wise investor once told us, you may be worried sick on a weekend trying to guess how certain events impact an excellent stock you are holding, but the promoter of the company maybe enjoying a round of golf! More seriously, what is the point of worrying about things that are beyond our control? Usually, the answer to that is, if we know too much about a developing situation, we should at least take steps to shield ourselves from the impact. Can we really do that? We believe it is delusion to think that we can.

Human beings have three natural tendencies: one, an unconscious and immediate need to make sense of events around them; two, overconfidence in our ability to make sense of them; and three, having made whatever sense we have, to arrive at conclusions, make forecasts and form opinions. We often fail in the last two these activities, but since we do not record the number of times our forecasts and opinions are wrong, we remain undeterred and continue. Fortunately, with the explosion of analysis and opinions available on social media, blog posts and websites, the blunders and faulty analysis and forecasting, even by the smartest experts, is there for all to see. Even this vast repertoire of well-documented follies, does not seem to have diminished our three natural tendencies enumerated here.

The reason why is it so hard to make sense of complex developments and make accurate forecasts is obvious. Any economic outcome is an interplay between ever-changing, complex and, often unseen factors. What is the possibility of getting the outcome right when we cannot see the multiple factors and changes in play? The economic fallout of Covid was impossible to predict, but weren't we all so clear that a global synchronised lockdown would push the world into a depression? Didn't we also believe that reopening of the economy would be a halting process and economic recovery a slow, tough climb? It is now evident that most parts of the economy are stronger than the pre-Covid levels for almost a year now. The September quarter will be very strong for almost all sectors. We are dead wrong, repeatedly.

The short point is that, we are hardwired to see patterns and meaning, and to worry, extrapolate and make simple correlations between complex events. This leads to forecasts that are largely wrong. If you were to ask me what impact will shooting raw material and energy prices have, I would say I don't know and neither does anyone else know for sure. The problems we are worrying about started with a huge surge in demand and that is a better problem to have than lack of demand.

2. Decision-making by us Vs. enterprises:

Our main point of interest is how will the companies in our portfolio negotiate these problems? We would rather let owners and management of these companies worry about the issues that they are facing. They have far better resources to do so, and in an enterprise economy, adjustments to external events are continuous and often unseen. For example, rising commodity prices lead to rising supply over the medium term, and to substitutes, over the long-term.

3. We have the power to exit

There is another reason we not try to seek too many explanations. As outside investors we are handicapped in not getting to know how the company is responding to external shocks. But on the other hand, we have a huge advantage. We can sell our stock. Trying to read into external events, making sense of them and then trying to correlate what it means for a specific company and its stock price is a roundabout and flawed way of arriving at what we need to know: whether to hold or sell. We would rather let the market tell us that directly.

A New Technical Lesson:

We have realised that we need to avoid some good quality stocks because they are less liquid and are in a 5% price band. At our current size of holding, we would not be able to sell these shares all at once, if we need to. I am allergic to this dreadful possibility. We prefer to have the option of selling our entire holding within an hour if need be, without breaking the price, and certainly not wait to do it over several days because the stock is illiquid. I certainly don't wish to see a stock locked down at 5% day after day, which will happen to some of these stocks, when the tide turns. Hence, as a matter of abundant caution, I have reluctantly decided to get out of such stocks even though their prospects remain bright. While these have given us good returns, we were simply fortunate not to be caught in a downward spiral of low liquidity and the 5% lower circuit that can go on for days.

New Climate, New Rules

I don't know if other fund managers believe this, but I believe that the rules of investing change with the market climate. We are changing two rules in the current market climate. First, we are going for more diversification. We had started out running concentrated portfolios. Now is the time for a diversified one -- smaller bets spread across a larger number of stocks. I had alluded to this in my last letter. You can read it here. We will diversify in number but also in the nature of stocks – value, growth and special situations. Secondly, we will scale in and scale out of our positions. So, don't be surprised if our starting position is about 1 or 1.5% in a stock. We need to be careful about the size of our positions, given the massive run up in all stock prices. Third, we will be doing a bit more of active management, with the *sole purpose* of protecting our gains and preventing losses, not for additional returns from trading. I have explained the logic of this rule, last time, here.

Happy Investing and greetings for the upcoming festive season.

Debashis Basu,
Founder & Principal Officer