On the Illusion of Knowledge

As I have been exposed to more writings from Howard Marks, I have become increasingly aware of his general theories and beliefs of investing and have found myself nodding in agreement as I read his essays. My views are becoming progressively more aligned with Marks' as his ideas apply to the randomness of the real world, as opposed to conforming to academic or mathematical economic theories. In his memo, "The Illusion of Knowledge," he highlights the inaccuracies of forecasting, why people continue to forecast, and most importantly, why the world is unpredictable enough and too complex to be able to predict the future.

He kicks off this memo with a quote by John Kenneth Galbraith, saying, "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." In a previous philosophy class I've taken, we discussed this flaw of intelligence - that there is ignorance in thinking you know everything, and the most intelligent people are able to understand that they do not know everything. There are things you know, things you know you don't know, but there is an entirely different group of things that you *don't even know* you don't know.

Essentially, we don't know many things until they happen. In fact, we don't know much about the market for certain until it actually does happen. Something that Marks points to in his memo is that there are occurrences that have a one in a billion chance of happening, but we experience billions and billions of occurrences in our lives, so we are actually very likely to stumble upon at least a few of these unlikely and wildly improbable situations. Before the internet was invented, we could not even fathom the possibility of being able to do what we can do with technology today, this is something that we did not yet know we didn't know, because the idea had not yet been created, and it was something that ended up changing our world forever.

The main point in his memo that Marks is trying to make is that the economy is something that is far too complex to predict or forecast - the best we can do is invest with the absence of that knowledge. Something that really stuck out to me in highlighting the ineffectiveness of forecasting was two different ways you can break them down. Because a lot of these big trends do not deviate from the past, most forecasts can be made by extrapolations of previous cycles - therefore, a lot of these types of forecasts are right, but this is not anything groundbreaking or contrarian, so much of it is anticipated by the market and therefore they do not gain higher market returns. On the other hand, you have forecasting that deviates greatly from the usual market patterns, which would be extremely profitable if they were correct, but because the market rarely deviates from these past trends most of these wild swings are wrong. Simply put, forecasting is something that is either correct and not very profitable or is something that deviates too much and can create a lucky win (maybe), but mostly big losses. We have discussed a lot of this riskiness throughout our class when discussing growth investors who may think that the future is something that can be predicted. They tend to go for these big wins, and do not care as much about the current value of the stock that value investors do but are instead interested in guessing the future of the stock and are mostly hit with losses because they struggle to properly figure out a stock's current value. For instance, the 2008 credit crisis was something that deviated from the market norm and previous cycles as it was something we had not yet seen before - the investors that won big, such as Michael Burry, were not necessarily economists who were forecasting, but were investors doing in depth research about the current state of the market and mortgage bonds; they were able to see something that others did not. If there was a forecast that would have predicted this, it would have been highly profitable, but would be like hitting a lottery jackpot as it did not happen before and has not happened since.

Psychology is something we have discussed heavily throughout this semester. During class, we watched a video with Seth Klarman who said investing is the intersection between psychology and economics. I had never thought about how large of a role psychology plays in investing and to hear it is one of the two major academic disciplines that make up investing was extremely thought provoking. When I used to think of investing, the main academic disciplines I thought of were economics, statistics, and finance, which are all heavily math based. I had not thought about the importance of understanding human psychosis and what drives human behavior with regards to investing, but after hearing this and its importance explained by marks, it makes total sense. Marks has called attention to the importance of understanding psychology as an investor in his book, *The Most Important Thing*, explaining that psychology plays a big part in when an investor buys, sells, or holds on for dear life. Being able to understand your own psychology and human behavior can help steady your mind and prevent panic selling at the bottom or getting wrapped up in the hype of buying an already overvalued stock in a bullish market.

The topic of stationarity was brought up during this memo, which I had never heard before. Fundamentally, stationarity is the idea that the big forces that impact a system don't change over time, however, it is fairly obvious that besides when talking about physical sciences like physics or chemistry, things that have never happened before, happen extremely often. Hence, there is an unpredictability of the market due to all the factors that go into driving the market conditions, including human behavior which is also extremely unpredictable. Marks paints a great depiction of why forecasting is not necessarily advantageous when outliers happen, he says, "the output from a model may point in the right direction much of the time, when the assumptions aren't violated. But it can't always be accurate, especially at critical moments such as inflection points . . . and that's when accurate predictions would be most valuable." Predicting single outcomes is hard enough, it is still predicting the future, but if it is a single factor, an investor may be more likely to predict correctly. The thing about the instruments that drive the market, such as inflation or unemployment, is that there are thousands of factors attributing to these outcomes and to predict those, one would have to be correct about all of those thousands of smaller things, which would be nearly impossible.

One way that some people try and forecast the future is by looking at the past - even Marks has discussed the importance of understanding cycles in his book. However, one thing that Marks plays at is that when investors rely too hard on historical references, these references may not necessarily be accurate and can misguide. He discussed that in past cycles, although there were similarities, there are more differences that outweigh these similarities. No two prior periods are the same, and even if there was a period that was exactly parallel to one being experienced in the market, Marks points out how inaccurate a sample size of one would be, to which I would definitely agree.

A question that was tugging at my thoughts, while reading the first half of Marks' memo was, if forecasting is so inaccurate and if the market is too complex for these forecasts to be of any benefit, why is it still being done? Why do so many people still rely on forecasting and why are people getting paid to make these inaccurate forecasts that do not earn above average returns? Fortunately, Marks dives into a multitude of reasoning as to why macro forecasting is still being practiced when it does not lead to any exceptional returns. Plenty of reasons point to the fact that it is something that has always been done, that these forecasts have always been created throughout the past and, therefore, to be taken seriously and attract clients, they need to produce forecasts. The main reason, however, is a bit more self-promoting or justifying. When I read this section of the memo, it struck home with me as I recently listened to a podcast that discusses something called the backfire effect. The backfire effect is basically the effect that is had on those who have their beliefs challenged: instead of opening their minds and understanding another perspective that may not align with their own beliefs, people tend to shut down and double down on their own opinion - hence the name the backfire effect. It is directly caused when trying to discuss new ideas with people who may not be interested in hearing another perspective or disagreeing opinion and have an already closed mind. You cannot open other people's minds for them, and often discussing differing ideas to open someone's mind, actually does the opposite.

Many investment managers or economists who use forecasting, use it in a way to justify their own personal interest or investment decisions. Nobody wants to forecast something that goes against their beliefs, so we seek confirmation bias to confirm what we already believe. Many of the people making forecasts tend to overstate the number of accurate forecasts they create and minimize the ones they were wrong about (which was probably plenty). Even when presented with evidence to the contrary, self-interest causes them to act in a certain way, and self-justification enables them to stick with their inaccurate ideas. In fact, sometimes, these forecasters blame unsuccessful forecasts on having been blindsided by random occurrences - which is extremely ironic, as the entire point of forecasting is to make an unpredictable, complex market seem simple and predictable.

Throughout our discussions in class about the efficient market hypothesis, we have seen textbook definitions of this hypothesis, and differing opinions from this textbook definition with both Marks and Montier. Marks touches on this theory in his memo when referencing how Warren Buffett believes that for a piece of information to be valuable it must be important and knowable. He agrees that the macro future is valuable, but it is not knowable, as the efficient market hypothesis would suggest, which would be why trying to forecast the macro future to make investment decisions could be detrimental to an investor. Marks does not necessarily believe that you can't beat the market, as the efficient market hypothesis would suggest, but he would say that you can't beat the market using macro-economic trends that no one can consistently know more about which is what matters in gaining knowledge advantage and making above average returns. Marks and Buffett would instead look at the micro aspects of a company's current valuation.

Toward the end of Marks' memo, he starts to explain two different types of investors: the "I know's" and the "I don't know's." While being in school with young people getting into investing, and after talking to friends and family about investing, I have definitely seen both types. Funny enough, I would say that the majority of students and friends that I have discussed investing with belong in the "I know" school of investing. One would think that because these people are younger and newer to investing, they would be more likely to be in the "I don't know" group, but I have realized it takes lots of humility for people to admit they do not know something, especially when it comes to their money. Convincing others and thus convincing themselves that they truly know something that nobody else in the market does could be their ultimate demise. These "I know" people, including my dad, think that they know what is going to happen in the future. They base their investments on news about inflation or interest rates, and while these things may be helpful in determining what our economy looks like right now, this should not give them the utmost confidence to talk about the market as if they *know* exactly what is going to happen. If these people truly know what is going to happen in the market, then my dad would not still be working and my friends would not be scrounging for jobs after college - but alas, they are.

I would say the majority of "sheep in the herd" of casual Robinhood investors are convinced that anyone can invest, just like the Robinhood ad that we viewed in class depicted, to which Marks would most certainly disagree, as we have seen. They believe that they can tell, by reading forecasts, what to do with investing without actually knowing how to value stocks or understanding what is overvalued and just catching the momentum of an already bull market. I think that because these past ten years we have had one of the longest bull runs, people actually do believe that they are amazing investors, without understanding that if you are getting good returns and the market is getting better returns, your returns are really not good at all. As Marks has said, though, this ignorance of people who think that they "know" is good for the rest of the real value investors - more people throwing their money in the market without taking a long hard look at what they are investing in means more money in the market for value investors to eventually gain.

As we have learned, you can't predict the market, but you can prepare. People in the "I don't know" group know this and understand that you cannot predict any future - which takes away cool points for them, when asked by friends and family what is going to happen in the market. On the upside however, while they might not get cool points for investing in big swinging growth stocks, they miss out on the heavy losses that these "I know" people take on when putting money in growth stocks that are overvalued and miss the mark.

One quote that really stuck with me at the end of this memo, was by a Stanford behaviorist, saying, "It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on." This really encapsulates the idea I spoke about before - with investors that think they can predict the future and know what is going to happen with momentum in stock. It is a much scarier thing to *think* you know, rather than knowing you don't know. This also ties back to multiple quotes we saw in the movies we discussed in like The Big Short and Moneyball - "It ain't what you don't know that gets you into trouble. It is what you know *for sure* that just ain't so" and "It's unbelievable how much you don't know about the game you have been playing all your life." Clearly, everyone is under the illusion of knowledge, but as an investor, being able to pick apart what is something that can be known and then also understanding what can't be known for certain, such as the future of the market, is incredibly important to be able to make great returns. Once an investor can grasp the knowledge that one cannot forecast or predict the outcome of a market, then they can make investment decisions adapting and understanding how to beat the market with the absence of this knowledge.