WILLIS INVESTMENT COUNSEL
Principled Investing

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WE DECEIVE OURSELVES WHEN WE REQUIRE KNOWABILITY

This will be the primary discussion topic at the April 26th WIC Annual Investment Briefing at the Quinlan.

Willis Investment Counsel was founded in 1979. For the last 43 years, we have written client memos such as this when a major geopolitical, economic, or market event occurred. In the early years, we probably thought we had answers and knew how things would unfold. <u>We now understand we can deceive ourselves when we require, or believe we have attained, knowability; when we believe we have more knowability than is possible.</u> We deceive ourselves and misjudge the situation when we succumb to the powerful human need to explain; when we force order into chaos; and when we choose mere plausibility over accepting uncertainty. I do not believe *deceive* is too strong. This memo thinks about Ukraine in this context of inherent unknowability.

<u>UKRAINE</u>

A few quotes from the March 5-11 issue of *The Economist* underscores the gravity of Russia's invasion of Ukraine (pages 9-10):

> Mr. Putin says he wants to drive NATO out of the former Warsaw Pact countries and America out of Europe.
>
> Others may conclude that Mr. Putin is insane and deterrence is hopeless. True, his goals are abhorrent, as are his means of achieving them. Neither does he have Russia's true interests at heart. But he nonetheless understands power and how to keep it.
>
> Russia's invasion of Ukraine could yet become the biggest military action in Europe since 1945.

In this March 14 online post, the *National Review* explained why a new cold war has dawned; quoting from the February 4th Putin-Xi Jinping joint statement:

> The new inter-State relations between Russia and China are superior to political and military alliances of the Cold War era. Friendship between the two states has no limits, there are no "forbidden" areas of cooperation …
>
> Russia and China stand against attempts by external forces to undermine security and stability in their common adjacent regions, intend to counter interference by outside forces in the internal affairs of sovereign countries under any pretext, oppose … revolutions in the aforementioned areas.

Of course, WIC has no special knowledge or insight about Russia's invasion of Ukraine, but we understand that it is a hugely important historical moment. We assume Putin is a corrupt ruler of a totalitarian state who likely does not think in rational and moral terms. We assume Russia's attempted takeover or occupation of Ukraine will be a protracted situation with many unforeseeable consequences. Beyond that, we do not pretend to know what lies ahead or the outcomes that may unfold.

Turning to *possible* economic consequences, if this war continues for several months or more, and we assume it will, we can envision:

- Supply chain complications; a setback in the easing of supply chain pressures
- Inflation pressure; not as *the cause* of continued high inflation, but as yet another factor that could contribute to a continued high level of inflation
- Oil and commodity prices remaining high, which in turn add inflationary pressures
- Uncertainty and the reversal of *animal spirits*; less willingness to take risks
- Reduction in "free trade" (never as "free" as many seem to believe)
- Continued heightened market volatility; while unsettling to many, its portfolio economic consequences should not be assigned significant weight
- Cybersecurity threats, even cyberwarfare; nothing new, just expanded

Cyberwarfare is worthy of more discussion.[1] Cybersecurity threats have grown increasingly pervasive and destructive over the past several years. Russian state-funded

[1] https://www.wsj.com/articles/virtual-front-attacks-invasion-ukraine-cybersecurity-attack-threat-hackers-russia-ukraine-dos-denial-of-service-energy-notpetya-11645221274
https://www.cisa.gov/uscert/ncas/alerts/aa22-011a
https://fortune.com/2022/02/24/what-if-russian-cyber-attacks-hit-west-ukraine-notpetya-ddos/
https://www.aljazeera.com/news/2022/3/10/putin-says-russia-will-emerge-stronger-sanctions-will-rebound

attacks on U.S. critical infrastructure now seems more likely given the economic sanctions against Russia. Just prior to Russia's invasion, Ukraine suffered their country's largest cyberattacks aimed at the Defense Ministry, Armed Services, and two state-owned banks. Ukraine is no stranger to Russian cyberattacks, and over the years their banks, media, transportation and energy sectors have been routinely hacked. In 2017, the White House reported that the NotPetya attack 'was the most destructive and costly cyberattack in history.'

Closer to home, the White House has attributed many cyberattacks to state-run Russian entities including last February, when they announced that the infamous SolarWinds hack impacted 9 federal agencies and about 100 private sector companies. On January 11, 2022 the Cybersecurity and Infrastructure Security Agency (consisting of NSA and FBI) stated that '*Russian state-sponsored actors have used sophisticated cyber capabilities to target a variety of U.S. and international critical infrastructure organizations, including those in the Defense Industrial Base as well as the Healthcare and Public Health, Energy, Telecommunications, and Government Facilities Sectors'*. While we can't predict the outcome, it would be naïve to believe that Russia will not consider more aggressive attacks, particularly as the U.S. led economic sanctions are viewed by Putin as *economic warfare*.

How do we think about these additional risks and uncertainties? How do we alter our investment strategy to deal with Ukraine? What do we now do differently?

PERHAPS RATIONAL AND PRUDENT, BUT PROBABLY NOT PRODUCTIVE

Reading a range of analysis by economists and investment firms not only educates us, but reveals what they are advising their clients. The same is true of journalists in the financial press. The following is representative of the commentary of firms and pundits we have been reading (although arguably rational and prudent, the following is not our advice):

- Increase cash to reduce equity market exposure; move toward a defensive posture
- Increase the bond component to reduce equity market exposure
- Increase portfolio exposure to oil and commodities
- Reduce allocation/exposure to Europe
- Add gold to one's portfolio
- Experiment with bitcoin and other crypto currencies

While all of these points can be rationally argued, they all assume one knows *when* to increase the portfolio allocation to relatively less-risky assets/strategies, and *when* to decrease such allocations; and by what amounts. It sounds prudent, sensible and smart to make such adjustments to tactically respond to the current geopolitical landscape.

However, for such adjustments (e.g., increasing the portfolio's cash level) to be productive, one not only must know the outcomes/probabilities in order to evaluate the risk/reward calculus, one needs to get the timing right. We believe it is almost impossible to *know* how all the elements of the Russia-Ukraine war will unfold, what unexpected and unforeseeable events will arise, what economic chain-reactions might develop, and how countries and investors might react. Because we believe making significant portfolio adjustments in the current environment requires knowledge that is unattainable, we prefer a different path.

WHAT ARE WE LEFT WITH? WHAT IS THE PATH FORWARD?

Because of the current structure of our clients' portfolios, we can prudently choose to sit tight. Why is that? **Our clients' portfolios have already been designed to withstand unexpected economic, pandemic and geopolitical events**. More specifically, the companies we own in our clients' portfolios (and in our personal portfolios), by design, have the financial strength, free cash flow generation capacity, debt level, and business model durability to withstand such unexpected events. That is part of risk management – understanding that you cannot know or anticipate all such negative events. We understand the decision to sit tight is as much a decision as making substantial portfolio adjustments. One might argue the knowledge to sit tight is not attainable either. Fair point.

So maybe it's *relative knowledge*; maybe it's about the decision-maker's confidence and conviction level. WIC has relatively little confidence in our ability to accurately and reliably forecast the direction and magnitude of future changes in the economy, interest rates, inflation, and the markets; and no ability to forecast the outcome of international conflicts and wars. We are not in the economic, market, or geopolitical forecasting business; that is a low-odds, high risk endeavor. We would deceive ourselves, and you, if we pretended to have the requisite clairvoyance to believe we had sufficient knowledge to make portfolio bets based on such non-existent precognition.

WIC does have confidence and a high conviction level in our ability to examine and understand a company's financial position and profitability. We talk internally, and externally with our clients, about owning *companies*. That is what we do – we own *companies* for ourselves and our clients. We do have adequate knowability about the companies we own as to their:

- Business models – adaptability, durability, and profitability
- Financial strength – competitive position, balance sheet, debt, cash flow
- Profitability – sales and margin trends
- Free cash flow – durability and sustainability
- Return on assets, on equity, and on invested capital
- Valuation

It is by understanding these characteristics of the companies we own that we can knowledgably evaluate to what extent we might need to be "worried" about unexpected events that arise – be it normal business disruptions or abnormal exogenous-type events such as pandemics and wars.

While we will continue to read broadly about Russia's invasion of Ukraine and the related potential economic consequences and how it might impact our companies, we do not believe substantial portfolio adjustments are needed because we are already appropriately diversified and our companies are financially resilient. But, we do expect there will be opportunities to initiate positions in companies we have been researching for months, in some cases years, for which we have only been waiting for a better entry point. We will selectively add to companies we now own to capitalize on their lower stock prices.

DO WE REALLY DECEIVE OURSELVES?[2]

Yes, we often do. Humans are wired to prefer – almost crave – an explanation. We so dislike uncertainty that we naturally seek order and explanations that need not be grounded in truth, reason or logic – mere plausibility is readily embraced.

It would appear that WIC's investment decision-making must begin with a strongly held belief about the direction of the economy, inflation, interest rates, markets, etc. To not operate that way almost appears naïve, superficial, and certainly unsophisticated. On the contrary, it is because reams of academic and empirical research have all but proven such forecasts are often wrong, that we have concluded forecasts are so unreliable it is a futile and counter-productive endeavor to base decisions thereon. Of course, we read and think about the research and opinions associated with these forecasts – it would be arrogant not to – but our focus continues to be on the operational performance (e.g., margin trends and free cash flow) of the companies we own for our clients and ourselves.

To reiterate, we draw the strength of our risk management convictions not from any forecast, but from the *companies* we own – the durability of their business models, the resilience of their underlying operations, and perhaps most important, the strength of their balance sheets to adapt and compete.

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[2] Overconfidence is one of the most powerful and insidious heuristics that often supplants rational thinking and decision-making. Epistemic arrogance – the tendency to overestimate our ability to predict when we are overconfident in our "knowledge" – further dilutes rational, probabilistic thinking that incorporates a range of information and possible, but unknowable, outcomes.