WILLIS INVESTMENT COUNSEL
principled investing

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UNCERTAINTY AND MARKET VOLATILITY SHOULD **NOT** BE SUCH BIG ISSUES

We often hear that we live in a world that has run amok. Many clients seem dismayed and perplexed by the world's instability, uncertainty, and volatility. This quarterly report cover letter offers some historical perspective.

MOST CONSIDER UNCERTAINTY PROBLEMATIC

Business school curriculum significantly focuses on dealing with uncertainty. The media – especially the market pundits – spends an inordinate amount of time on uncertainty. Likewise, clients frequently express concern about uncertainty in terms of a potential threat to their portfolios. Regardless of the context, uncertainty is usually considered a "bad thing" that needs to be mitigated, avoided, or dealt with. Why is it so important to deal with uncertainty? Why isn't uncertainty considered to be the normal state of the economy, politics, markets, and investment outcomes?

HISTORY INDICATES UNCERTAINTY IS CONSTANT AND NORMAL

We all know the world stays in a constant state of flux, but we do not seem to effectively reflect that knowledge in our evaluation of world events. A perusal of news headlines for the last 100 years would cause amazement, wonder, shock, sadness, disbelief – a full range of emotions. Be it war, innovation, technological advancement, natural disasters, medical miracles, human atrocities, or political hope/despair, it is normal for the world to be in a constant state of flux, change, and uncertainty. **Stability is *abnormal*.**

History clearly teaches us that uncertainty is always the norm. Again, this is obvious and well-known. So why so much concern and bewilderment? The following reminds us that past decades were characterized by events that caused the same sense of despair, worry, anxiety, and uncertainty that many speak of today:

1960s – The Cuban missile crisis; the U.S. enters Vietnam War; John F. Kennedy, Martin Luther King, Jr., and Robert Kennedy are assassinated; Moon landing

1970s – The U.S. is still mired in Vietnam; the Soviet Union invades Afghanistan; the Jonestown Massacre and the Munich Olympics Massacre; a partial meltdown of the nuclear plant at Three Mile Island; Watergate and Nixon resignation

1980s –The Berlin Wall falls; Mount St. Helens erupts; Exxon Valdez oil spill in Alaska; AIDS crisis begins in the U.S.; famine in Ethiopia kills an estimated 1 million people; prime rate hits 21%; President Reagan shot; Black Monday

1990s – Desert Shield/Storm in Iraq; the internet becomes widely accessible; Oklahoma City bombing; Columbine school shootings; Cold War ends; genocide in Rwanda; Soviet Union dissolves

2000s – September 11 attack on the U.S.; Global War on Terror/Operation Enduring Freedom/Operation Iraqi Freedom/Afghanistan; Enron files for bankruptcy; the space shuttle Challenger explodes shortly after lift-off; Hurricane Katrina; Dot.Com bubble bursts; Lehman Brother collapses; Great Recession, including housing and banking debacle; smart phones; Gore-Bush election challenged in Supreme Court

2010s – Boston Marathon bombing; Obamacare; Supreme Court hands down a landmark same-sex marriage decision; church shooting in Charleston; launch of Apple iPhone;

2020s – COVID-19; reversal of 20-year trend of low inflation and interest rates; Russia invades Ukraine; artificial intelligence; presidential election issue; January 6 U.S. Capitol incident

Of course, the foregoing is but a small subset of the events one could list that illustrate how the world often feels adrift and dangerous.

OUR BRAINS CRAVE CERTAINTY[1]

Again, uncertainty is completely normal. It is equally **normal** that our brains intensely dislike uncertainty. It's how we are wired, literally. It is human nature – normal – for us to seek answers, to prefer explanations, to prefer order to chaos, and to be unsatisfied with too many unanswered questions and unknowns. The **normal** condition for our brains, our perception, and our evaluation of events is to dislike – even hate – uncertainty.

To the human mind, uncertainty equals danger. *Psychology Today* explains uncertainty this way:

> If your brain doesn't know what's around the corner, it can't keep you out of harm's way. It always assumes the worst, over-personalizes threats, and jumps to conclusions. Your brain will do almost anything for the sake of certainty. And you're hardwired to overestimate threats and underestimate your ability to handle them—all in the name of survival. Our brains invent all sorts of untested stories looking for plausible explanations. We prefer a plausible explanation to no explanation. We tend to assume our worst-case assumptions as fact (the reality does not matter; plausible is good enough).

[1] This section includes paraphrased text from *Psychology Today*, Brian Robinson; *The Nuance*; *The Harvard Business Review*, Heidi Grant and Tal Goldhamer; and *Thinking, Fast and Slow* by Daniel Kahneman.

The Nuance explains the insidious emotional power of uncertainty this way:

> Uncertainty acts like rocket fuel for worry; uncertainty causes people to see threats everywhere they look, and at the same time, it makes them more likely to react emotionally in response to those threats. The more uncertainty there is — especially if that uncertainty is coupled with gloomy hypotheticals — the more likely the brain is to conjure up and fixate on the worst-case scenarios.

The Harvard Business Review describes uncertainty in terms of threats:

> When things become less predictable — and therefore less controllable — we experience a strong state of threat. We tend to feel even more threatened when "the threat" could potentially have serious consequences – such as a fear of losing money.

Daniel Kahneman won the Noble Prize in Economic Sciences for his research in psychology that challenged the rational model of judgment and decision-making. His book *Thinking, Fast And Slow* includes critical insights about how our brains are essentially wired to deal irrationally with uncertainty. Some excerpts follow with page numbers indicated:

> … headlines satisfy our need for coherence … a large event is supposed to have consequences, and consequences need causes to explain them … adept at finding a coherent causal story… (p. 75)

> … System 1 (our reactive mind) is gullible and biased to believe … the confirmatory bias of System 1 favors uncritical acceptance of suggestions and exaggerations of the likelihood of extreme and improbable events … (p. 81)

> … System 1 (our reactive and often uncritical, less examining mind) excels at constructing the best possible story that incorporates ideas currently activated, but it does not (and cannot) allow for information it does not have … when information is scarce, System 1 operates as **a machine for jumping to conclusions** (emphasis supplied, p. 85)

> … The illusion that one has understood the past feeds into the further illusion that one can predict and control the future. These illusions are comforting. They reduce the anxiety that we would experience if we allowed ourselves to fully acknowledge the uncertainties of existence. We all have a need for the reassuring message that actions have appropriate consequences and that success will reward wisdom and courage … (p. 205)

> … when an unlikely event becomes the focus of attention, we will assign it much more weight than the probability deserves … (p. 316)

We believe the psychology of decision-making is as important as finance, accounting, and economics combined.

UNCERTAINTY AND MARKET VOLATILITY SHOULD **NOT** BE SUCH BIG ISSUES

WIC believes the attention given to uncertainty and volatility is unwarranted. What is normal should not get so much attention. We believe it is misleading to design portfolios as if uncertainty does not exist. It is disingenuous to pretend risk, return, and outcomes are knowable. **They are not**. We cannot make uncertainty go away. We cannot delete uncertainty, unknowable outcomes, volatility, and risk from portfolios. Uncertainty, unknowable outcomes, volatility, and risk simply go with the territory. Period.

Therefore, the client conversation about portfolio design should be along these lines:

- Uncertainty is normal
- Uncertainty cannot be "converted" into certainty
- Portfolio outcomes (especially inside of ten years) are unknowable
- Unknowable outcomes go with the territory
- It is unrealistic to believe otherwise

With the foregoing reality established, how do we make portfolio decisions in a world that is constantly in flux, and often in a state of bewildering change? How do we confidently allocate our clients' capital among our strategies when uncertainty and risk appear extreme? How do we evaluate companies to own in our clients' portfolios?

We have been here many times and can draw on that experience. Perhaps even more instructive than our navigation of COVID-19 and Russia invading Ukraine, is how we evaluated the Great Recession of 2007-2009 (which was largely precipitated by the housing and mortgage/banking debacle).

The following is an excerpt from a memo on our website dated January 15, 2014, titled *The Road Not Taken.* This excerpt describes our thinking and decision-making process during 2008-2014, and it applies equally today:

> Robert Frost's signature poem perfectly captures the choice before WIC five years ago. This memo looks back at the five years beginning in 2009 when the market meltdown was at its worst, and investors had to choose which road to travel:
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> ***Retreat*** – the response of those who believed the world had fundamentally changed and the risk associated with investing in companies was unacceptable. These investors chose a road (a strategy) of sitting out the storm in cash and bonds with little allocated to equities; or, alternatively, a strategy of broad diversification away from U.S. equities. Market timing was embraced.[2]

[2] As used here, *retreat* refers to those investment committees, investors, and portfolio managers who chose to either significantly increase cash or bonds (to be more defensive), or who chose a strategy of very broad diversification in an effort to "hedge their bets" by allocating capital across a wide array of strategies, often away from U.S. equities.

Engage – the response of those who believed economies and markets are resilient and concluded markets/investors were over-weighting the negatives. These investors chose a road of traditional diversification to balance the risk of further downside with the risk of lost upside opportunity and capital recovery. Some who chose (or maintained) this road emphasized U.S.-based multi-national companies that had the financial wherewithal to survive and prosper; and chose to rely on the lessons of history about economic and market cycles (and about investor behavior). Market timing was rejected.

The equity allocation strategic decision that committees and investors (and their portfolio managers) had to make five years ago about which road to travel is the same decision that had to be made over and over throughout the last five years as an unrelenting parade of negatives remained front page news – *retreat or engage*. **Throughout the last five years, WIC chose to *engage* by remaining fully invested in U.S. companies that had the financial wherewithal to survive the storm and compete in global markets.** *And that less traveled decision to engage has made all the difference*.

Not being overly influenced by unrelenting negative headlines is critical to risk management. Remembering and understanding the natural ebb and flow of politics, hegemony, economies, and markets are critical to risk management. That, along with choosing to engage and not retreat, made all the difference 13 years ago. Our post-Great Recession decisions were effective and successful.

A similar number of uncertainties exist today; they are just different. Challenges surrounding inflation, political noise, geopolitical tensions (including with technology), climate change, and the impact of Artificial Intelligence (AI) seem alarming to some. Each may be very important; however, the longstanding forces of the economy still boil down to supply and demand, growth versus stagnation, fear versus greed, and the normal ebb and flow of those forces. This uncertainty will always exist. Because we cannot predict what will happen, we manage the uncertainty by increasing our odds of success by investing in companies that we believe can and will endure the troubling scenarios most conjure up.

We will continue to manage uncertainty and risk by reading a range of experts, studying history, debating among ourselves, and remaining independent so we can think and act impartially. Importantly, most of our time is spent thinking in terms of ***owning companies*** for many years versus reacting to market trends. That includes being very focused on our companies' (i) business model durability, (ii) debt and leverage posture, (iii) overall financial strength and related ability to adapt and compete, and (iv) cash flow generation reliability.

We welcome your questions and thoughts and always enjoy hearing from you. Please remember that we continue to be invested alongside you.

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