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The circle of our competence

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Should investors still follow Warren Buffett? Given that his favourite types of stock (defensive ones with monopoly power) are now more fully priced than they were a few years ago, it’s doubtful. But there’s one aspect of his thinking we should respect – his emphasis on having a well-defined “circle of competence”.

His long-term partner Charlie Munger has said that one of their skills “is knowing the edge of your own competency”. They distinguish clearly between what they know and what they don’t, and they avoid mistakes by avoiding what they don’t know.

Which poses the question: what is it that we can be sure we know, and sure we don’t?

Knowledge is not merely a strong belief. Nor is it a plausible story. Nor is it a set of facts that are already in the price. Nor is it company accounts, as the collapse of Wirecard reminds us. And nor is it a fund manager’s good track record. Investors who relied upon Neil Woodford’s past performance learned Mark Twain’s saying: “It ain’t what you don’t know that gets you into trouble. It's what you know for sure that just ain't so.”
In fact, there’s a lot we don’t know. Not least of these is the future.

Prakash Loungani, an IMF economist, has shown that economists systematically fail to predict recessions. Economic forecasts, then, are not within our circle of competency.

Granted, history tells us that some indicators have done a better job, such as bond yield curves and ratios of consumer spending to wealth. And measures such as foreign buying of US equities and dividend yields have done a decent job of predicting equity returns. All these, however, run into the same problem – of what Richard Bookstaber, author of *The End of Theory*, calls radical uncertainty. We have no assurance at all that past relationships will continue to hold in the future.

But do we need to predict the future? Simple diversification works: portfolios comprising equities,gilts, gold, cash and foreign currency have held up well during crises, including this year’s pandemic.

Here again, however, we run into radical uncertainty. Diversified portfolios have done well in recent years because bonds have delivered great returns, often during times of losses for equities. We cannot be confident of this continuing. Diversification is the best we can do. But it might not be very good.

If we don’t know the future, what do we know?

One thing is that very few stock-picking strategies actually work. Researchers have unearthed dozens of “anomalies”, ways of predicting outperformance. But Duke University’s Campbell Harvey says most of these are “likely false”. And John Cotter and Niall McGeever at University College Dublin have shown that the anomalies that do exist often get bid away as investors wake up to them.

A big reason for all this is simply that there are very few genuinely good stocks. Hendrik Bessembinder at Arizona State University has shown that most stocks around the world underperform cash during their lifetime. The good long-term rises we’ve seen in markets, he says, are due largely to the 1 per cent of stellar-performing shares. But identifying these is very difficult.

All of which leads to something else we know – that it’s very hard to spot which fund managers will beat the market. Cass Business School’s David Blake says the “vast majority”
of them are “genuinely unskilled”. And even good track records can come to a sudden and nasty end.

All this argues for keeping our money in tracker funds.

There are two exceptions to this, however. We do know that momentum and defensive stocks outperform. Not every one of them of course, nor do they do so month-in, month-out. But, over the longer term, on average they do. We know this because of evidence from around the world, from different time periods and even different assets.

We know something else – that there are some mistakes investors make that systematically lose them money. For example:

- We hold onto losing stocks in the hope they’ll turn around, thus exposing ourselves to negative momentum.

- We’re overconfident (because we don’t know the edge of our competency) and so trade too much and over-estimate our ability to spot good fund managers.

- We buy types of stock that systematically underperform on average, such as small speculative ones or ones that are newly floated.

- We are overly influenced by peer pressure and word of mouth, which can lead us to buy overpriced stocks.

We don’t know much about how to make money. And we certainly don’t know how to make it quickly. But we do know how not to lose it egregiously.

All this suggests a strategy for staying within the circle of our competence. We should diversify across assets, but without any firm expectation of great success; we should prefer tracker funds, but use momentum or defensives if we really must pick stocks; and we must avoid well-known errors.

Perhaps, though, the distinction between what we know and what we don’t is not always useful. As investors we have to prepare for the future even though we don’t know what it holds. But at least we should know that we don’t know.