AMI INVESTMENT MANAGEMENT
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Suppose a month and a half ago we told you that Congress and the President wouldnøt reach a deal over the fiscal cliff until the eleventh hour and that the compromise, while increasing federal revenues, would largely avoid the tough choices required on long-term budget challenges as well as set the stage for another political showdown over the debt ceiling and automatic sequestrations in just two to three months. How would you predict the stock market would behave? Weød venture to bet that you wouldnøt have forecasted a largely uninterrupted 9% gain in the S&P 500 from the lows of mid-November through the close of business on January 2nd. Ratings agency Moodyøs wasnøt so sanguine, warning that the deal doesnøt bring enough long-term deficit reduction to avoid a potential ratings downgrade (Moodyøs counterpart S&P downgraded the U.S. after the 2011 debt ceiling showdown). In an interview on NPR, David Wessel, economics editor for the *Wall Street Journal*, was asked why stocks had done so well in the face of so little progress on Capitol Hill; his response ó õYeah, I canøt figure out the stock markets.ö

With the nice gains to close out the year, the S&P 500 finished up 16.0% for 2012. International markets posted a strong 2012 after a weak 2011, with developed markets returning 17.9% and emerging markets 19.0%, as measured by the relevant MSCI indexes. Bonds, as measured by the Citigroup 1-10 year Treasury index, returned 1.7%, reflecting the depressed level of interest rates.

Stocksø recent strength is a good reminder of the futility of trying to forecast short-term market movements. So many variables and factors affect stock prices over short time frames that it boggles our minds that so much effort is put into coming up with six or twelve month market forecasts.

In *The Signal and the Noise*, statistician and author Nate Silver, who has successfully predicted baseball player performance and election outcomes, studies õwhy so many predictions fail ó but some donøt.ö In the book Silver describes the work of psychologist Philip Tetlock, who conducted a comprehensive twenty year study that examined predictions from experts across a variety of fields.

> Tetlockøs conclusion was damning. The experts in his survey ó regardless of their occupation, experience, or subfield ó had done barely any better than random chance, and they had done worse than even rudimentary statistical methods at predicting future political eventsí It didnøt matter whether the experts were making predictions about economics, domestic politics, or international affairs; their judgment was equally bad across the board.[1]

If experts are so bad at forecasting, why does our society pay so much attention to them? It isnøt that forecasting isnøt important or canøt add value, itøs just that experts have a propensity to focus on the wrong things. For instance, Silver chronicles the great strides the National Weather Service has made in forecasting weather over the past fifty years. Yet despite the fact that the National Weather Serviceøs data is free to anyone, local television meteorologists continue to issue frequently inaccurate weather forecasts.

[1] Silver, Nate, *The Signal and the Noise: Why So Many Predictions Fail – But Some Don't*, The Penguin Press, New York, 2012.

There are two reasons that account for this. First, commercial weather services tend to overestimate the chances of adverse weather on purpose because viewers are much more upset when they are surprised by rain as opposed to sunshine. In other words, the forecasters have an economic incentive to inflate the chances of inclement weather. Secondly, and more importantly, the local weather industry isnøt that focused on accuracy to begin with. One local weatherman proclaimed, õThereøs not an evaluation of accuracy in hiring meteorologists. Presentation takes precedence over accuracy.ö[2]

Tetlockøs research led him to differentiate between two types of experts ó hedgehogs and foxes.[3] Hedgehogs are industry insiders with type A personalities who have focused the bulk of their careers in a narrow field of study. Foxes, on the other hand, are multidisciplinary thinkers that are more tolerant and welcoming of different ideas and approaches. Foxes are much more likely to take a probabilistic view of the world and remain cognizant of what they can and canøt know; as a result, they make much better forecasters. Hedgehogs, however, make for much better TV.

> Big, bold, hedgehog-like predictions, in other words, are more likely to get you on televisioní Foxes sometimes have more trouble fitting into type A cultures like television, business, and politics. Their belief that many problems are hard to forecast ó and that we should be explicit about accounting for these uncertainties ó may be mistaken for a lack of self-confidence. Their pluralistic approach may be mistaken for a lack of convictioní
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> But foxes happen to make much better predictions. They are quicker to recognize how noisy the data can be, and they are less inclined to chase false signals. They know more about what they donøt know.
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> If youøre looking for a doctor to predict the course of a medical condition or an investment adviser to maximize the return on your retirement savings, you may want to entrust a fox. She might make more modest claims about what she is able to achieve ó but she is much more likely to actually realize them.[4]

The hedgehog-fox distinction is millenniums old. When the Oracle of Delphi told Aristotle that he was the wisest man alive, he was initially skeptical. But after he sought out a supposed expert of his time, the philosopher concluded:

> I am wiser than this man: neither of us knows anything that is really worth knowing, but he thinks that he has knowledge when he has not, while I, having no knowledge, do not think that I have. I seem, at any rate, to be a little wiser than he is on this point: I do not think that I know what I do not know.ö[5]

Warren Buffett has achieved his outstanding investment record by channeling his inner-Aristotle:

> If we have a strength, it is in recognizing when we are operating well within our circle of competence and when we are approaching the perimeter.[6]

In the short-term, foxes can look out of touch or indecisive. But as economist John Maynard Keynes once said, õIød rather be vaguely right than precisely wrong.ö Decision makers that are always forecasting great shifts or dramatic changes are bound to meet poor results; our world is just not that simple. Foxes, on the other hand, practice discipline and patience, waiting to make a significant call or forecast only when they are strongly supported by evidence, data and reasoning. In fields like investing, foxes also consider their downside in the case that their forecast is wrong (remember, everything is *probabilistic*). Author and frequent critic of so-called experts Nassim Taleb advises:

> *Don't look for the* precise *and the* local. Simply, do not be narrow-minded. The great discoverer Pasteur, who came up with the notion that chance favors the prepared, understood that you do not look for something particular every morning but work hard to let contingency enter your life. As Yogi Berra, another great thinker, said, õYou got to be very careful if you donøt know where youøre going, because you might not get there.ö
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> Likewise, do not try to predict precise Black Swans [rare events] ó it tends to make you more vulnerable to the ones you did not predictí Remember that infinite vigilance is not possible.

[2] Ibid.
[3] Based on a passage from the Greek poet Archilochus: õThe fox knows many little things, but the hedgehog knows one big thing.ö
[4] Ibid.

[5] Platoøs Apology 21a-d by F.J. Church (rev. Cumming).
[6] Buffett, Warren, *1999 Letter to Berkshire Hathaway Shareholders*, March 1, 2000.

> *Seize any opportunity, or anything that looks like opportunity.* They are rare, much rarer than you thinkí I am sometimes shocked at how little people realize that these opportunities do not grow on trees.[7]

We try to be as fox-like as possible, focusing on what we feel we can know and insulating ourselves as much as possible from what we canøt know. This entails sticking to our core investment principles:

- Minimizing expenses and transaction costs
- Diversifying portfolios across different asset classes, such as bonds and international stocks
- Remaining committed to equities as long as stock prices arenøt unjustifiably high
- Heavily researching individual investment opportunities that (a) we can understand, (b) are associated with trustworthy management teams and (c) offer a high *probability* of a favorable investment outcome under conservative assumptions.

We donøt hope or expect to beat markets every quarter or year. Instead our goal is to avoid any permanent impairments of capital and to compound our clientsø assets at an attractive long-term rate above inflation.

The next months will see a lot of hedgehogs predicting what Congress will or will not do and how Wall Street may react. We will instead be focused on trying to build investment portfolios that are prepared for the inevitable uncertainty of our economy. Unfortunately, the strong returns in stock and bond markets over the past several years have reduced the investorøs margin of safety going forward. At this time, though, we donøt think stocks are expensive enough to justify a material reduction in exposure nor do we see attractive alternatives (bonds and real estate offer historically low yields). Yet higher stock market averages make it harder for us to find individual stocks that we are excited about. Weøve purchased several companies over the past couple of months, but in each case the prices rose before we could build more substantial positions. But our noses remain to the grindstone and we hope that 2013 will bring us opportunities similar to those weøve been able to find over the past few years. Patience and discipline are the keys to successful investing.

As always, we thank you for your continued confidence.

Sincerely,

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"I know nothing about the subject, but I'm happy to give you my expert opinion."

[7] Taleb, Nassim Nicholas, *The Black Swan: The Impact of the Highly Improbable*, Random House, New York, 2007.