The heart of the matter

Uncertainty creates the opportunity that is fundamental to markets and must be embraced by investors. **Peter Bernstein** provides some food for thought.

Cast thy bread upon the waters: for thou shalt find it after many days.
Ecclesiastes, XI, 1

What is at the essence of good investment? The short answer is you pays your money and you takes your choice. As the articles in this Financial Times series reveal, investors are confronted with a dizzying array of instruments, strategies, goals and controls, a drumbeat of advice and counsel from experts, and a deluge of statistics.

Worse, most of these seem to have short half-lives: yesterday's answer often turns out to be tomorrow's wrong number.

Inflation looms or subsides, growth waxes and wanes, policies shift, instruments appear, markets evolve, returns spreads break precedents, and fresh information floods in.

And yet, beneath all this lies the essence of investment: the hidden future. If we held the key to that mystery, we would have no need for the elaborate investment paraphernalia that confronts us and we could dispense with experts and their mountains of statistics.

One instrument and strategy would suffice. But the key to the secret is denied us. Fleeting shadows are all we can discern.

Those who believe they can distinguish between light and shadow back there are fooling themselves. Surprise in investing is inescapable, not an incidental anomaly. If the road ahead were always clear, we would readily adjust to what we see and tomorrow's price would always equal today's.

But capital markets are continuously assailed by the unexpected. How else can we explain volatility? Just the experience of the past three decades is sufficient to prove the point.

The hidden future

Nevertheless, uncertainty is friend as well as enemy. Only with uncertainty is there opportunity. If we knew the whole future, returns would be baked in the cake and decision-making would be a lost art.

Investors devote too little time considering what they can glean from the distinction between a hypothetical future we know for certain and the real world of uncertainty we face each day.

What would happen if we were empowered to remove uncertainty from tomorrow? Even though no one has ever been to that hypothetical world, we can discover a clear and simple answer to this question, drawn from the real world itself.

In their calmer moments, investors recognise their inability to know what the future holds. In moments of extreme panic or enthusiasm, however, they become remarkably bold in their predictions: they act as though uncertainty has vanished and the outcome is beyond doubt.

Reality is abruptly transformed into that hypothetical future where the outcome is known. These are rare occasions, but they are also unforgettable: major tops and bottoms in markets are defined by this switch from doubt to certainty.

The switch is precisely why these are major tops and bottoms: at such moments, convictions about the future are so strong that no force is left to extend the current price trend further in the direction from which it has come.

The cake is baked, just as in the hypothetical world where the future is truly known. If, in the real world, the future evolves as anticipated, asset prices will go nowhere at best.

But if expectations are exaggerated by panic or euphoria, asset prices will go into reverse. If expectations are wrong, betting against the majority will pay off in a big way.

Consider the long-term bond market in the autumn of 1981, when year-on-year inflation in the US had already passed its peak of close to 15% and was on the verge of dropping into single digits.

This time is especially vivid for me, because I came close to being thrown out of a meeting for recommending to a charitable foundation that they sell all their US Treasury bills, then yielding about 10 per cent, to dive into the long-term Treasury market where yields were 14%.

The investment committee I was confronting included the president of a bank whose primary business was investment management, a senior partner of one of the big Wall Street houses and a managing partner of a famous consulting firm, to say nothing of a group of timorous creatures from outside business and finance.

Judging from his red complexion, the bank president appeared to be on the verge of apoplexy.

My argument, however, was simple and did not depend on a forecast, even though I could hardly believe the US would succumb to double-digit inflation for another 30 years.

With yields at 14%, there was little to lose even if the frightened men had sufficient foresight to know for certain that inflation was a long way from coming under control.

If they were wrong, however, there was a killing to be had. And a killing indeed it was. The yield on Treasury bills fell by 600 basis points over the next year and kept on going downwards.

It is naive to believe that majority opinions are always wrong. On the other hand, the outcomes when such opinions are right may be entirely different from what may happen when the majority is wrong. There is where opportunity lies.

The business of risk

At the same time, however, the enemy is often ourselves: uncertainty means our decisions can turn out to be wrong.

The goal of investment has always been wealth creation, but the process of investment must involve managing uncertainty, or cushioning the impact of surprise. Nothing else explains the variety of instruments and strategies, and the endless thirst for information that confront us.

Some investors face the challenges of uncertainty by exercising direct control over the outcome of their decisions — they give up liquidity by owning the majority share of their businesses.

But the great mass of investors are minority and passive participants, powerless to influence the fate of the enterprises on which they choose to depend. This is a role no rational person would accept without a valid exit strategy.

Hence, these investors manage uncertainty by accumulating paper assets with ready markets where they can expect their decisions to be reversible.

This choice in favour of marketable securities opens two paths to increased wealth. The first is the cash flow that would accrue to any owner or lender.

The second path is unique to this form of investment: minority investors in marketable assets must pin their hopes on the prices other investors will pay for these assets, or on the willingness and ability of debtors to live up to their contracts to repay principal.

Cash flows plus the resources — and whims — of others comprise the total payoff from these investment choices. Both components of total return are outside the control of the investor. So is the future value of money. Investment is risky.

In the old days, investors came to grips with uncertainty by applying a mass of foolishness, rules of thumb, narrow mindsets and mythology. Stocks, by and large, were for the adventurous or for investors who limited their equity exposures to a small percentage of their total wealth.

Risk management for other investors meant settling primarily for cash flows from debt instruments, eschewing the exquisite risks of depending on others to set the value of their assets.

Until the mid-1950s at least, legal trusts in the US were limited in what they could hold in equities, while so-called "prudent man rules" kept many trustees on the defensive until well into the 1980s.

After all, during the near-150 years between the end of the Napoleonic wars and the onset of the second world war, inflation was only a wartime phenomenon, making the purchasing power from high-grade bond yields about as close to certainty as anything could be, in dramatic contrast to the volatility of stock returns.

The harrowing years of the Great Depression and the terrifying inflation shocks of the 1960s and 1970s provided investors with hard lessons about how little they knew about what the future held for either stocks or bonds.

At the same time, however, these experiences inspired academics to build a powerful set of theories to explain the nature of investment and the behaviour of financial markets.

Even with the limitations of theory,