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Market Ethos

The latest market insights from the Richardson GMP team

Premortem – what if we are wrong

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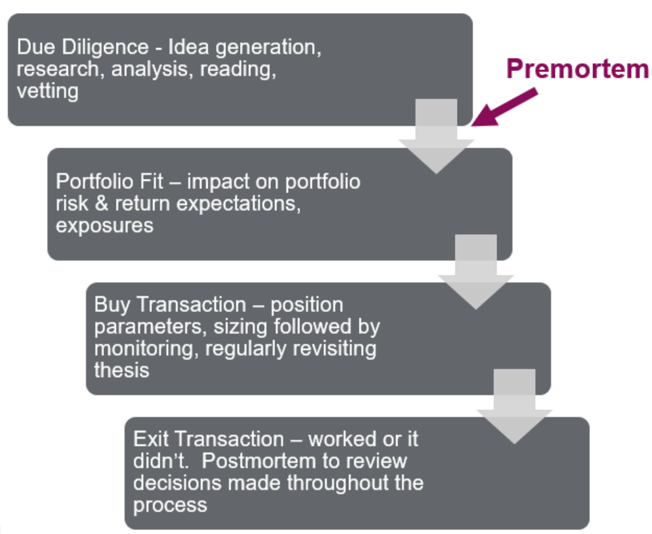
We all have behavioural biases that influence our decision-making processes. These biases help us make decisions, often quicker and with less effort than conducting a more thorough analysis. However, when it comes to investing, biases tend to mislead more often than help us. As a result, adding steps to your investment decision-making process that counter or mitigate the impact of biases can go a long way in avoiding behavioural mistakes. Confirmation and overconfidence biases are prominent biases when it comes to investing but adding a **premortem** to your process can help reduce the negative impact of these biases.

Confirmation bias. This occurs when an individual seeks out and evaluates information in a way that supports their pre-existing view. It is natural for us to want to read or hear information that supports our views. People also tend to discredit or place limited weight on contrary views. This bias is closely associated with anchoring. The danger for an investment process is that you may miss or ignore evidence that goes against your view or choice of holdings.

Overconfidence bias. We all tend to have a higher confidence in our abilities than statistical evidence would support. The percentage of people who believe they are above-average drivers is one of the most popular examples. This bias can lead to excessive risk-taking, concentrated portfolio positions and of course hubris.

Adding a premortem to your investment process can help mitigate these biases. A premortem is a mental exercise that occurs before a trade/position is added or that is applied to an existing position. This can apply to an individual equity, bond, fund or strategy. Essentially, you force yourself or your team to hypothesize why the investment could fail or not work out as planned.



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The graphic on page 1 is an abbreviated investment process from idea inception and due diligence, to trading, monitoring and finally exiting. Ideally the premortem occurs after an investment idea has passed due diligence but before implementation. There are no hard and fixed rules for a premortem, but we have created suggested steps (*See the 8 steps on the right*).

The goal is to open the mind to alternative scenarios. In fact, doing this should prompt you to consider contrary evidence differently. It also creates a sense of doubt. Put this together and overconfidence and confirmation biases should be mitigated.

Here's an example, for illustrative purposes only.

Premortem

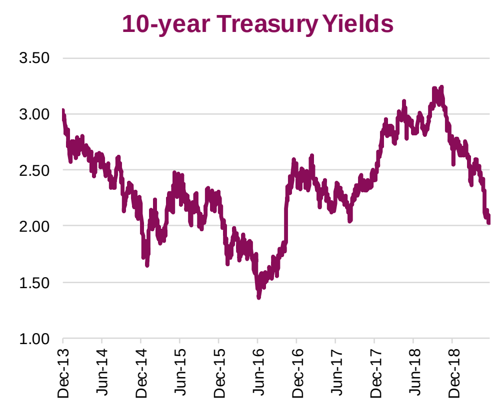
1. Imagine the investment does not work out
2. Why – most likely causes
3. Considering outside views
4. Low probability, high impact risk?
5. Trying to uncover unknown unknowns
6. Do you still believe it's a good trade?
7. Has your perceived probability of success changed?
8. Can the risks be hedged or mitigated?

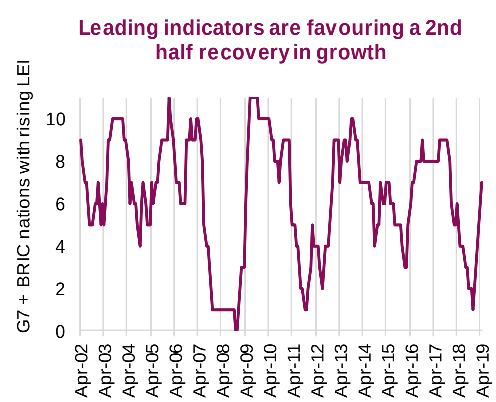
The example: Long TBT

Let's say we believe the bond market has overreacted to a more dovish position by the U.S. Federal Reserve (Fed). We will concede the economic data has softened and the Fed has moved from hawkish to dovish as 2019 has progressed. Consequently, the Fed Funds futures are now pricing in 100% of a cut in July and a 65% chance we will have three cuts before year end. This has pushed 10-year Treasury bond yields down to 2.0%, a level not seen since Barack Obama was president.

Many believe this could be an overreaction. Keep in mind leading indicators are up over the past three months in the U.S. and many other key economies. U.S. unemployment is low and initial jobless claims are not rising. Plus, equity markets are at all-time highs. If there was a crisis to support cutting rates, it certainly is not evident just yet. And if we get some progress on trade, things could get a lot more growth-oriented quickly.

Given this view, let's say you believe yields are going to move higher from these depressed levels and you consider buying the Proshares Ultrashort 20+ Year Treasury ETF (TBT). This ETF will rise in value if bond yields go up.





Premortem: What if bond yields fail to rise?

It's bound to happen; even great investment managers make calls that don't pan out. Considering that a 60% winning percentage is enough to be successful, it means that trades can fail at a pretty high rate, that's why the planning phase is so important. It's essential to surround yourself with a differentiated team, i.e. not one full of 'yes people', but dissenters who are knowledgeable and can voice concerns and worries. At this premortem phase, we're driven by one key question: what might go wrong?

In the example of TBT, what might go wrong is simple: **Bond yields fail to rise** and continue to drift lower in the back half of the year. It's important to consider all the reasons as to why this could happen.

We see the following as key risks to the view yields will rise:

- The trade war escalates or continues to weigh on growth
- Global economic growth continues to slow and the manufacturing slowdown intensifies resulting in an imminent recession.
- Inflation expectations continue to fall
- Middle East tensions rise, bringing with it the risk of war. This could in the short term drive a flight to safe-haven assets.

- Central bank politics with President Trump micromanaging Fed policy. European Central Bank President Mario Draghi's words have increased the pressure on Fed Chair Jerome Powell to follow suit. Pressure from the U.S. president to lower rates and restart its own quantitative easing (QE) program in part to weaken the dollar.

These are all plausible scenarios. The fact is, the very exercise of a thorough and comprehensive premortem raises doubt. It may be difficult or challenging but anticipating developments that can undermine our outlook gives us an opportunity to put plans in place to manage these risks and adjust accordingly. This should be combined with a systematic stop-loss strategy that allows you to define specific capital at risk for each position – another essential tool for proper risk management. Risk management carried out in a more methodical manner is an essential way to diminish the behavioural drag on portfolio performance. A premortem is not a be-all and end-all strategy for investment success; but it does make it easier to make rational decisions, especially under pressure.

Investment thoughts

Including a premortem in your process will not make you avoid all mistakes. Sometimes, it may even cause you to be more conservative and lose out on maximizing the profit from a great idea. However, the benefits of thinking outside the box (box being your pre-existing view) and considering alternatives fosters critical thinking. And critical thinking more often than not helps people come to better decisions.

Source: All charts are sourced to Bloomberg L.P. and Richardson GMP.