

Volume 2 //

# Acuity

The greatest wealth is **your peace of mind...**



## Making tough decisions in an uncertain world



“ I’ve got all the money I’ll ever need,  
if I die by four o’clock. ”  
Henny Youngman

## Summary – key messages

We inevitably have to make financial decisions that materially affect our futures in an uncertain and complex environment. How can we make good decisions that ensure we maximise the chances that we will end up with the outcome we want?

- Many aspects of our lives and the markets are uncertain, making decisions both complex and taxing, both practically and emotionally.
- Your best hope for a good outcome is a good decision process followed by good implementation.
- Insightful financial planning helps us to understand the uncertainty that we face in our lives and to put in place sensible, yet flexible, plans that give us a good chance of achieving our goals.
- A robust investment process, founded on evidence and a balanced decision making process, helps to reduce uncertainty and closely manage the uncertainty that remains.

## Facing up to uncertainty, with the help of Donald Rumsfeld

Donald Rumsfeld, the former US Defence Secretary, certainly added to the lexicon of the concept of uncertainty with his ‘*known-knowns; known-unknowns; and unknown-unknowns*’<sup>i</sup> interview, when describing the link between Al Qaeda and the Saddam regime in Iraq. While it confused many (not least The British Plain English Campaign, who ironically commented: ‘*We think we know what he means...but we don’t know if we really know.*’), it does provide us with a useful framework for understanding the uncertainty that we all face as we seek to put in place sensible plans for our finances, not least how to invest our liquid assets.

We face a number of critical decisions on our life journeys from young, family and career-orientated adults, through the inflection point of leaving the workforce and hopefully onto a happy, healthy, long and financially secure retirement. These include decisions such as: **When to retire? How much is enough? How much can we spend? What should we invest in? Or can we afford to gift the children some capital at this point?**

## Please remember to die aged exactly 99

The challenge we face is that these decisions are made against the backdrop of great uncertainty - in our lives, the capital markets and the rapidly changing world we live in - but make those decisions we must, if we are to give ourselves the best opportunity to achieve the things we aspire to do with the wealth that we have. These sorts of decisions would be easy if we knew that we were going to die at the age of 99 and could obtain a return, year-in year-out, of say, 4% above the rate of inflation! You may see some similarity here with the overly simplistic models that some advisors or investment websites offer.

But that is not the real world – our lives and the markets contain much more uncertainty than that. Perhaps the most valuable contribution that a good, unconflicted advisor can play now, and in the years ahead, is facilitating you to feel empowered to make the best decisions that you can in the face of this uncertainty. Let us take a look at this with a little help from Donald Rumsfeld, the former US Defence Secretary.

## What are the ‘known-knowns’?

If we look at the ‘known-knowns’ we can come up with a list that acts as both a starting point and platform for making decisions. It includes:

- How much wealth you have today, where it is and who owns it.
- Your current income and expenditure.
- Your current rates of income tax and potential inheritance tax liability.
- Your vision of what you want your money to achieve for you (financial security, help for the children, philanthropic works).
- The principal options for investing it, which are simply being either to lend it to someone (bonds) or to become an owner of companies (equities).
- The returns that have been exhibited on an historical basis for investing in bonds and equities of different kinds.
- The fact these returns do not come in straight lines.
- Some basic principals of investing that we know to work effectively.

## What are the ‘known-unknowns’?

Now we step into perhaps less comfortable territory, not least because we are faced with thinking about our own mortality:

- We know we are going to die, but we do not know when, either in our own case or in the case of our partners or other family members.
- We know that life takes many turns and that the future that we envisage for ourselves may well not to be the one that we experience. As the old adage reminds us *‘Life is what happens to you when you are busy making plans’*.
- We know that investment returns do not come in straight lines, but we do not have much of a clue as to what the rewards of lending or ownership will be this year, next year or indeed over the lifetime for which we will be investing. We can make some sensible estimates, but these are by no means guaranteed.
- We know that we can make use of statistics to try and measure this uncertainty to calculate its risk (the probability of certain outcomes occurring), but we do not know if it portrays the real world closely, or if it will be applicable in the period ahead.
- We know that there are some really smart investment professionals out there who could manage our money for us. The unknown is that we have no reliable means of identifying, with any certainty, who they are today.
- We know we could do with some help, but do not necessarily know who to turn to or who we can trust.

## What are the ‘unknown-unknowns’?

Well if we knew what they were, they would be ‘*known-unknowns*’. In the financial world, these potential events have become known as ‘*Black Swans*’, a phrase coined by Nassim Nicholas Taleb in his insightful book *Fooled by Randomness*<sup>ii</sup>, which makes the point that just because most swans are white, it does not mean that black swans do not exist. He describes a Black Swan event as: being beyond the realms of regular expectations; carrying extreme impact; and which is prone to us concocting spurious explanations as to why it happened and how it could have been predicted. Interestingly, he also views it as being the inverse – i.e. the non-occurrence of events that seem highly likely. **What could these be?**

- A computer virus that wipes clean all electronic records of stock ownership?<sup>iii</sup>
- A nuclear explosion at Fort Knox’s gold reserves (as was nearly experienced in James Bond’s Gold Finger).
- That all financial assets deliver negative returns in the years ahead.
- Others? - Your guess is as good as ours.

How we incorporate these events into our thinking is taxing, but we must try and do what we can to ensure that we incorporate robustness and flexibility into our planning.

## Is there any hope? (The quick answer is ‘Yes’)

It is all very well working out our own Rumsfeldian list, but how does that help us to manage the uncertainty? The short answer is that it helps us to identify where the risks lie as we try and plan for the future and to put in place sensible strategies to mitigate the unknowns that we face. It also illustrates the need to run a range of scenarios, in some instances, so that we can form some insight into what the various possible outcomes may be, where we draw our red lines, and what choices we face in these circumstances. This is where a professional financial planner adds considerable value.

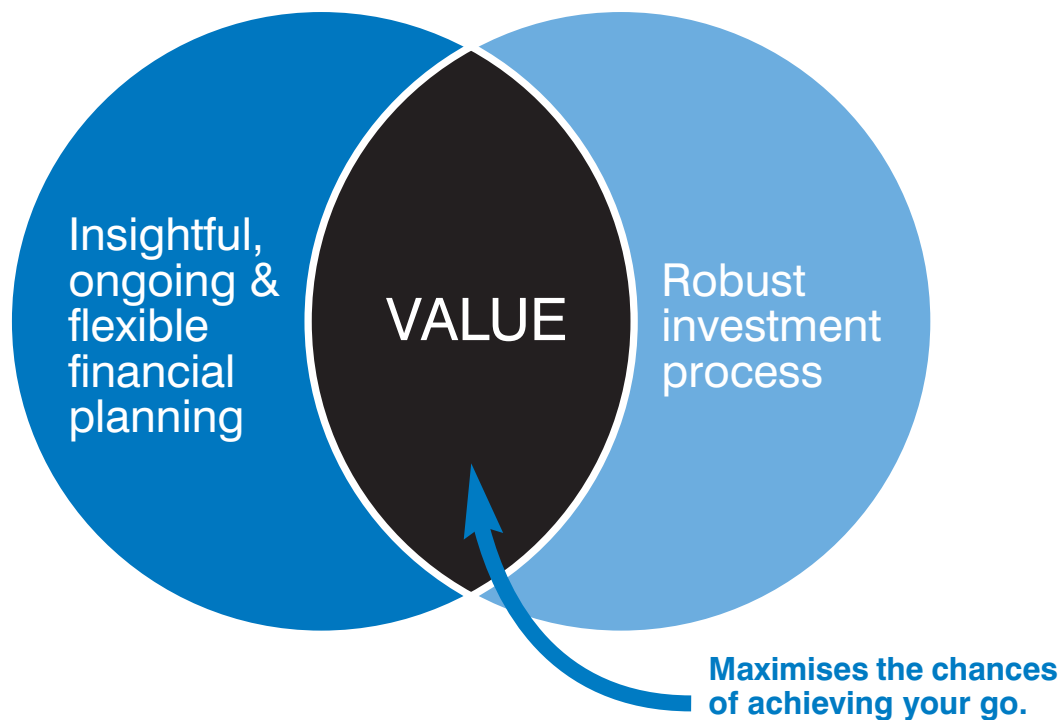
Traditionally, financial advisors have tended to take an over simplistic view of the world, selling products to fill financial holes, such as endowment plans, pretending that the ‘*known-unknowns*’ were really ‘*known-knowns*’, such as ‘*we can pick managers who can beat the market*’ or ‘*equities should deliver 10% a year*’. It is hardly surprising that the conflicted, commission-based advisory world has had so many misselling complaints lodged against it over the past decade.

## The solution lies in (boring) process!

A new breed of professional advisors – the fee-based financial planning firm – exists to help its clients make these decisions with clarity and confidence in the face of the uncertainty of life and markets. Insightful, structured, and yet flexible financial planning process, combined with a robust investment process, are the essential ingredients for maximising the chances of enjoying a financial outcome, and thus lifestyle, that is not only acceptable, but hoped for – ‘*Yes you can still go to South Africa to play golf, again, this year.*’

A sound process that helps to frame the problems that we face correctly helps us to make better decisions as a consequence.

## The essential blend of financial planning and robust investment process



### The financial planning process

Sound financial planning is, somewhat surprisingly, one of the best-kept secrets in the world of private finance. Akin to the preparation of a balance sheet, profit & loss statement and forward-looking management accounts, which allow companies to manage their assets, liabilities and cash flow into the future, financial planning does the same at an individual level.

Life-time cash flow modelling tools can help to gauge quantum and direction of decisions, and assist with scenario planning, as needed. However, numerical precision needs to be avoided as it sets a false sense of certainty in an uncertain world. As Russo and Schoemaker stated in their excellent book *'Winning Decisions'*<sup>iv</sup>:

**“ In an uncertain environment, rigour is not found in precise single point predictions, but rather in precisely defined uncertainty estimates. It is not obtained by selecting one right vision for the future, but through a rigorous process that will enable you to anticipate and prepare for multiple futures. ”**

Discussing the issues with an advisor, running a range of scenarios and gaining a sense of the likelihood of achieving the outcome you wish for (and the risks to it), helps most clients to feel much clearer and more comfortable about their wealth, their future and the decisions they may face along the way.

### The robust investment process

A good financial planning process helps to identify the three components that define how much investment risk a client needs to take: the first component is how much risk can they tolerate, which is a psychological trait; the second is defining their financial capacity for losses, which is a function of their wealth and future lifestyle needs; and the third is the financial risk that they need to take to achieve their goals. Discussing how to align these three components is one of the most important financial conversations that anyone will ever have. Only once this is agreed, can a sensible and suitable investment portfolio be structured.

In investing there are no absolute right or wrong answers, only better and worse solutions. Better solutions are founded in process that encompasses insight into the problem (what should we invest in), are focused on reducing uncertainty (with as little risk as possible) and a robust and consistent decision making process (should we go right or left at this decision point?). As Albert Einstein stated *“Make it as simple as possible but no simpler”*, which has been our mantra as we have built and implemented our evidence-based approach to investing.

In essence, it encapsulates the following core principles:

- Capitalism works and we should use it to do the heavy lifting as we try to generate returns from our portfolio as either owners (equities) or lenders (bonds). Finding the right balance between the two is key.
- Markets work pretty well - they are a zero-sum game before costs<sup>v</sup>. The evidence tells us that few professionals ‘win’ over the sorts of time frame we are interested in and they are well-nigh impossible to identify in advance. Using ‘passive’ funds that seek to deliver the return of the markets make sense.
- The mix of assets we choose to hold dominates the return journey that we will experience. It is what we focus on.
- We seek to take risks carefully that deliver adequate rewards, over time.
- We diversify all portfolios broadly; at the security, geography and asset class levels.
- We keep an eagle eye on costs of all kinds to ensure that you receive as much of the return on offer from the markets as possible.
- We rebalance this mix of risks regularly, back to the level of risk that is most appropriate for your circumstances.

Over the course of the next few ‘Acuity’ articles, we will be exploring these concepts in greater depth.

## In conclusion

Whilst many would argue over Donald Rumsfeld’s political contribution, his framework for thinking about the great uncertainty that exists in our world, our lives and the capital markets is a useful one. In the face of this uncertainty, we need to use the *‘known-knowns’* as our starting point, the *‘known-unknowns’* as a basis for analysis and scenario planning to get a tighter handle on the possible range of future outcomes; and the *‘unknown-unknowns’* as a reminder of the limitations of our knowledge and our need for flexibility and resilience. Sound financial planning and robust investment process are two key elements for managing this uncertainty.

We hope that you have enjoyed this paper. Please do not hesitate to call if you have any questions or comments on it. Our next topic in two months time is: **If risk is the answer – what is the question?**

## End notes

- i <http://www.youtube.com/watch?v=GiPe1OiKQuk&NR=1>
- ii Taleb, N. N., (2004) Fooled by Randomness, The Hidden Role of Chance in Life and the Markets, Texere, NY: NY. For those of you who do not fancy wading through a whole book, you may like to take a look at his home page: <http://www.fooledbyrandomness.com> where you can find a summary of his ideas.
- iii A recent project in the US revealed that it only took a professional hacker one day to hack into and control the software that manages the chemicals that are put into drinking water in Southern California. It does not take much to imagine the consequences.  
<http://articles.latimes.com/2011/mar/28/nation/la-na-cyber-war-20110328>
- iv Russo, J. E., Schoemaker, P. J. H., (2002) Winning Decisions, Doubleday, NY:NY pp102
- v If there are only two investors in a hypothetical market and the first owns all the stocks that beat the market, then, by definition the other investor must own all the losing stocks. The aggregate of their two portfolios is the market return, before costs.

## Other notes and risk warnings

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