Uncertainty, Outcomes & Our Decisions

Forecasting company, FiveThirtyEight – founded by Nate Silver, has an excellent track record when predicting future outcomes, particularly within the political arena. Nate Silver is the modern day EF Hutton. When he predicts, people listen. Or more accurately, when he predicts it is almost a foregone conclusion. Until it's not.

In the summer of 2015, Nate Silver gave Donald Trump a 2% chance of winning his party's nomination. This prediction may have actually helped the Donald as many of his former Republican nominees point to the fact that they didn't pay much attention to him early on – they didn't think he was a serious candidate. And with odds of winning just 2%, why would they?

The Game We Play

Our brains are terrible at interpreting probabilities. It requires a lot of thought and analysis. It means we have to think statistically, which most of us prefer not to do. Instead, we simplify probabilities whenever possible. And when probabilities are very high or very low, we come to certain conclusions. We interpret the 2% chance as "not going to happen" and we interpret the 95% probability as "definitely will happen."

Think about weather forecasts. If the chance for rain is 10%, we take little thought for rain. We instead conclude that it is not going to rain. And when it does rain, we are surprised and often blame the meteorologist for "missing it." But a 10% chance means that some of the time it will actually rain. So the meteorologist was technically correct.

Probability and the Markets

We all want to know what is going to happen in the markets. If we can know what's going to happen, then we can grow our assets in good times and protect them in bad times. The problem is the economy and financial markets are uncertain and probabilistic systems. In the face of uncertainty, which our brains don't like, we seek out some degree of certainty. We are attracted to forecasters and market experts who will tell us what is going to happen. And we confuse their popularity and confidence with their ability to predict the future.

There are lots of "Who would have thought?" in the market each year. Who would have thought interest rates would be this low? Who would have thought foreign rates would be negative? Who would have thought the Brexit would recover two days after a quick selloff and significant media coverage? Who would have thought in our modern day that a complete systemic shut down of cash could happen (financial crisis)? I could go on and on.

Investing Takeaway

The truth is we can think of a lot of things that have occurred that cause us, and market experts, to scratch our heads. Surprises and uncertainty are just about the only certainty in the markets.

We can't control the markets or the economy. We can't rely on expert forecasts, no matter how confident they are or appealing they sound. Even those forecasts with low or high probabilities aren't sure things – sometimes the unexpected happens.

But we can control how we respond…the choices we make. That's why having a financial plan is an important element to successful investing. We are in control of our plan and we are in control of our decisions. We should expect unexpected things to happen…they always have. But rather than try to predict it (which we are no good at) let's spend our energy figuring what we will do when the unexpected happens.

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