How Do We Know We Are Right

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A first-level answer I heard early on in my career from some portfolio managers is something along the lines of, “If the market price of the security that you bought goes up more than the index, then you were right, if it doesn’t, then you were wrong. Period.” This is a naïve and in my opinion flawed view of both the investment process, and what market prices tell us about a security. To elaborate, it is helpful to reduce the investment process to a simplified mental model.

The “urn and ticket” mental model for an investment

Suppose you are offered an opportunity to buy a ticket that gives you the right to draw one ball from an urn. That urn is filled with eight green balls and two red balls, a fact that you have no reason to doubt. The process of choosing a ball from the urn is purely random. If you draw a green ball then you will be paid $100 with certainty, and if you draw a red ball you will get nothing.

It is your lucky day–the seller of the tickets has offered you a ticket for $50. You quickly calculate that the expected value of that ticket is $80, and make the purchase. The drawing is to happen three months from now, and so you eagerly await your opportunity to win the prize. At the end of the first month, you observe that John, who bought an identical ticket,sold it to Bob for $40. You weren’t the only one to observe that–Mike, your ticket value administrator, also happened to notice this transaction.Since it is the only one available, he helpfully sends you your statement with the month-end Net Asset Value (NAV) of your ticket “marked” at $40.

Unperturbed by the news from Mike that the market price of your ticket has declined, you finally reach the end of the three month period and have an opportunity to draw ball from the urn. One of two things can happen –you draw a green ball and get paid $100 or you draw a red ball and get nothing. Before you get the chance to draw your ball,however,you encounter another participant, Jim, who on the way to the drawing tells you that he paid $90 for his identical ticket. As you wait in line, Jim confides in you that the reason he made the purchase was that he “had too much cash, and his clients weren’t paying him to hold cash as they had already made the capital allocation decision for him.

Drawing Realized Outcomes

		You	
		Green Ball	Red Ball
Jim	Green Ball	You: +$50. Good Process, Good Outcome Jim: +$10. Bad Process, Good Outcome	You: -$50. Good Process, Bad Outcome Jim: +$10. Bad Process, Good Outcome
	Red ball	You: +$50. Good Process, Good Outcome Jim: -$90. Bad Process, Bad Outcome	You: -$50. Good Process, Bad Outcome Jim: -$90. Bad Process, Bad Outcome

Hopefully you would agree that you made a good decision by buying the ticket well below its expected value, even though 20% of the time you will have an unfavorable outcome that will result in a realized loss on your investment of $50. Similarly, Jim made a decision to pay more than the expected value of the ticket, yet 20% of the time he will have a realized gain on his investment of $10 even though his decision had negative expected value before the outcome was known. This illustrates why even with realized results after an investment has been exited, the outcome itself doesn't necessarily tell you if the investment was a good one.

The "urn and ticket" mental model in the real world

There are two main differences between the simplified example above and the real world of estimating the value of a business. If we were to continue with the example of an urn with different colored balls as an analogy for a business with different potential financial outcomes, the two main differences would be:

In the real world, the number of the balls in the urn –the financial outcomes of a business –usually cannot be known with certainty ahead of time. That being said, there are various ways that we can go about estimating what is in the "urn". In some cases this may lead to a reasonable range of what is inside, but in other cases,no matter how often we rattle the urn or try to peek inside, we cannot obtain a reasonable estimate of what is within. This is why a key tenet of my investment process is to only attempt to value businesses that possess characteristics that make their long-term economics sufficiently predictable so as to yield a reasonable range of values.

In the real world, the number and type of balls in the urn can change over time. Competitive dynamics and the results of management's capital allocation decisions can both either increase or decrease the financial outcomes of the business in the future. So even if you knew with certainty the contents of the urn at the time you purchase the ticket, the contents would likely be different by the time the drawing is held. This highlights the importance of my focus on businesses whose value I believe is likely to increase over time as a result of a strong competitive position and management that is likely to undertake value creating capital allocation decisions.

How can we know whether an investment decision was a good one at the time that it was made? Unfortunately, there is no answer that is as clear cut as our urn and ticket example. Sometimes an undesired financial outcome will happen, and it will still be a matter of opinion as to whether the initial investment decision was a good one or not.We will not always know if we paid a good price for the ticket but happened to draw an unlikely unfavorable ball from the urn. Other times, the passage of time will make it clear whether we were correct or not in our initial decision to invest.

Here are some signs that my initial investment decision was wrong:

The worst-case value estimate has declined materially over time. While we can't know the future precisely, estimating the lower bound of the likely value range correctly is a key part of my investment process.Therefore, getting the range of values wrong is a much bigger mistake than being incorrect with respect to where the Base Case lies within the range.

The assessment of the quality of the business or management team needed to be materially revised downward. Since I rely on these quality assessments both for deciding whether to invest and for sizing the investment, getting one of these judgments wrong is a process error.

Making a mistake in analyzing the balance sheet in a way that causes a material unexpected impairment of the value of the business. There are situations where other factors can make a decision to invest in a security where the balance sheet has room for improvement correct as a function of other considerations such as the risk-reward ratio. However, taking on that risk without realizing it and without demanding commensurately higher expected return is a mistake.

Key economic variables that were identified as material to the value range are tracking worse than expected for a prolonged period of time.

My investment thesis used to justify the value range continues to evolve over time, and I find myself making statements such as “yes, my initial thesis did not pan out, BUT…,” with the end of that statement usually referring to how inexpensive the security is now.

Here are some signs that our initial investment decision was correct:

An acquirer purchases the business at a price consistent with my value appraisal.

A fixed-income security I analyzed as likely to continue fully paying interest and return the principal matures, and we get the expected interest and principal.

My intrinsic value range goes up over time, at least in line with the 10% discount rate that I used in deriving it. Importantly, this is supported by visible fundamental improvements in the business, not vague or unsubstantiated estimates about the distant future.

Key economic variables that were identified as material to the value range are tracking as or better than expected for a prolonged period.

You might observe from the above that only in a few scenarios does one get near-certainty that the initial investment was a good one. In other cases, the odds begin to move in one direction or the other, with the judgment still far from certain. Ultimately, that is why as I recommended in the Owner’s Manual in the short-term the best thing to track is the investment process, but in the very long-term the majority of the weight should be placed on the outcome. Over a period of many years the outcome should converge with the process, and room for subjective judgment regarding the quality of one’s decisions should greatly diminish.