

Risk: Confirmation Bias and the Onset of Blindness as We Develop “Clarity”

The Unknown

As we know,

There are known knowns.

There are things we know we know.

We also know

There are known unknowns.

That is to say

We know there are some things

We do not know.

But there are also unknown unknowns,

The ones we don't know

We don't know.

—Donald Rumsfeld, Feb. 12, 2002, Department of Defense news briefing

Who knew that Donald Rumsfeld was such an adept Risk Manager? The point is well taken. With regard to our investments, as you likely know, every trade idea at Tiburon is looked at through the lens of our *Five Pronged Methodology*. This is the linchpin, in our view, of a scalable business, creating peer-beating returns with low downside deviation. Nonetheless, every trade idea has risk *exogenous* to the trade. That is, there are at least two critical, broad risks to consider: 1) There are the risks we contemplate and that we seek and receive compensation for as part of the risk/reward assessment. For us, this is the risk of the occurrence of our foreseen *Revaluation Catalyst(s)* – that/those event(s) that will move securities we may be long or short, in a step-function change to fair value. 2) There are those risks we identify to be outside of the trade thesis, i.e., exogenous to the trade thesis. Tiburon professionals and risk management (internal and external) will conceive the most correlated and effective hedges to wring this risk out. However, as Donald Rumsfeld would point out, we've then contemplated, probability weighted and where effective and desirable, hedged out the known risks - *what about the risks we don't know that we don't know?*



The Dangers of Bogus Math and Observances that Seem “Empirical”

Not only are there risks we don't know we don't know, but we routinely gather data deemed empirical that reinforce our beliefs, eventually blinding us to, or lessening our sense of the probabilities of risk. I will pull another reference out in demonstrating this concept of risks we don't know that we don't know (at the risk of angering some of my quant and academic friends).

An acquaintance of mine, Nassim Taleb, the writer of “The Black Swan” puts it this way:

I start with my old crusade against "quants" (people like me who do mathematical work in finance), economists, and bank risk managers, my prime perpetrators of iatrogenic risks (the healer killing the patient). Why iatrogenic risks? Because, not only have economists been unable to prove that their models work, but no one managed to prove that the use of a model that does not work is neutral, that it does not increase blind risk taking, hence the accumulation of hidden risks.

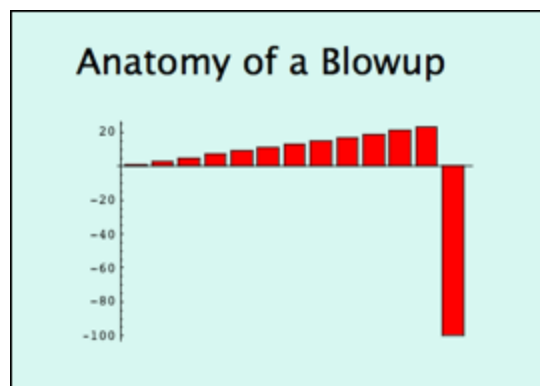


Figure 1 My classical metaphor: A Turkey is fed for a 1000 days (up and until Thanksgiving) —every days confirms to its statistical department that the human race cares about its welfare "with increased statistical significance". On the 1001st day, the turkey has a surprise. OOPS!!

The More Clarity the Less Vision

Investment professionals will spend endless hours tinkering with models, listening to company conference calls, doing channel checks, meeting management, competitors, etc. Few, however can ring *Confirmation Bias* out of their work. Like the turkey, actively chronicling its daily access to housing and food from altruistic humans, most investment professionals have a tendency to develop an impartial view *and then* actively seek data that support their supposition. Confirmation Bias, the human trait of seeking and interpreting evidence that is partial to existing beliefs, expectation and hypothesis, is a risk of *human bias* that can only be wrung out of portfolio, in my view, with a rigorous and agnostic investment methodology and risk culture that actively engages in *objective* scenario analysis. A recent Wall Street Journal article quoted a vast psychological study that concluded that people were twice as likely to seek information that confirms what they already believe as they are to consider evidence that would question those beliefs. Do we not have some covenantal obligation to investors as a fiduciary to wring out this risk as well?



