The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

Superforecasting: Summary (Part 5)

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In the last few issues, I've discussed Philip Tetlock's seminal book *Superforecasting*, including the research behind it, and the characteristics and 10 Commandments of Superforecasters.

Now I'd like to review the book's lessons related to investing and financial planning – and how our approach to stock selection fits in with those lessons.

A vital lesson was to beware of "articulate incompetents." Foxes, or careful, cautious types, make the best forecasters, but confident hedgehogs make more interesting forecasts. Hedgehogs are therefore more likely to be interviewed on media and act as spokespersons. These well-spoken, opinionated forecasters are skilled at seducing you into making mistakes.

A good tip for distinguishing foxes from *hedgehogs* is to listen for "however" vs. "moreover." Aware of different points of view, foxes use the word "however." Trying to fit everything into their narrow view, hedgehogs use "moreover."

Of Tetlock's 10 Commandments, I believe the first – *Triage* – is the most important: Some things are forecastable, but others aren't. Don't fall into the trap of trying to forecast things that are too complex or random to forecast.

For example, currencies and oil prices are notoriously hard to forecast. I'd also add the overall economy and the stock market's movements over the short-term (e.g., under five to 10 years). Amazingly, many people continue forecasting things that are impossible to predict.

While the overall stock market is impossible to predict over the short-term, I believe that the relative performance of different stocks has some degree of predictability. However, with the traps that come from our emotions and biases, it would take a true Superforecaster to succeed using a subjective approach. I believe an alternative approach of using objective factors – a disciplined set of strategies – does many of the same things a Superforecaster would do.

In fact, disciplined strategies incorporate many of Tetlock's Commandments:

Commandment 1: *Triage*. Individual businesses are influenced by many factors, but are a small fraction of the overall economy or the stock market. They should fit into the sweet spot of forecastable things.

Commandment 2: *Break problems down to smaller problems.* Our strategies each use several factors, which we then combine for an overall ranking.

Commandment 3: *Balance inside and outside.* We base the choice of the factors on historical testing of each factor and strategy as a whole. So, we base factors and weightings on the outside view, then apply them to individual companies.

Commandment 4: *Balance under-reacting and over-reacting.* Our strategies rank each company, and have sell points set roughly 20% from the top. We don't over-react to small changes, but when changes become significant, we take action.

Commandment 5: *Look for clashing causal forces.* Each of our strategies uses a variety of factors, plus we incorporate several different strategies into an overall portfolio.

Commandment 6: *Distinguish as many degrees of doubt as the problem permits, but no more.* We have a limit in each strategy on the number of factors we include, and also the number of strategies we use. While we personally verify each buy and sell, we're careful not to override the strategies without clear reasons.

Commandment 7: *Balance under-confidence and over-confidence.* We believe in our strategies, but we still buy 50 to 60 different stocks. It's still a bit of a numbers game, and we want the law of large numbers to work in our favour.

Commandment 8: *Look for the errors behind your mistakes but beware of hindsight bias.* We regularly review the performance of each strategy and the strategies as a whole. There is little possibility of hindsight bias, as we base each of our decisions on objective criteria.

Commandment 11: *Don't treat commandments as commandments.* While we have great trust in our strategies, we personally verify each buy and sell, ensuring the data is accurate, before taking action.

Useful, articulate and well-researched, *Superforecasting* supports our disciplined, objective approach to selecting stocks. It also provides great lessons for those still wishing to use a more subjective approach. ■

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