



Imagination and Investing

We usually associate the human faculty of imagination with activities like the creative arts and children's play, not investing. However, investors would benefit from considering the role that imagination plays in their decision-making process. Some historical thinkers, like the late English poet William Blake, believed that imagination exceeds reason as the most important human mental faculty. Giving some credence to his views, more business schools now offering courses in creativity. We cannot doubt the importance of imagination in investing when we consider that every product created by business was once only an image in someone's brain.

The CBC Radio show "Ideas" recently aired a thought-provoking 2-part documentary called "Imagination" that explores the role of imagination in our lives. Still available for download online, it contained several insights relevant to business and investing. First, as Albert Einstein once said, imagination is more important than knowledge. Investment knowledge such as facts about industries and companies rapidly becomes stale. Try to imagine an industry unaffected by technological change. As change occurs, investors who can imagine a wide range of potential consequences and beneficiaries will have an advantage. Conversely, the inability to imagine disruptive change leads to poor risk management. It is fair to place some of the blame for the 2007-2008 global financial crisis on a lack of imagination. Many analysts and investors took comfort in the knowledge that US housing prices had not fallen on a national basis for over 50 years. They could not envision the consequences of poor mortgage lending practices. Those investment managers who profited spectacularly from the decline in the value of mortgage securities simply acted on their vision of what was likely to happen, without requiring the validation of a historical precedent.

The CBC documentary mentions an evolutionary perspective on imagination. To help us survive, our brains developed to allow us to envision the results of an action without doing it. As investors, we can use this ability to stress-test our investment ideas under various hypothetical circumstances. For example, can we imagine how the strengthening of a macroeconomic trend like an increase in U.S. oil production or U.S. housing starts would impact our investments? Can we see the risks and benefits to various companies if we imagine such a trend reversing? If we do this imaginary work, we will be prepared to act decisively when change occurs.

As long-term investors we should also explicitly acknowledge that we are relying on the management and employees of the companies we own to imagine and innovate. If they do not, we are in the vulnerable position of being patient investors in a business that will someday fail. This is why we should favor companies with policies of fostering innovation and creativity. Companies like Google Inc. (GOOG-NASDAQ) and 3M Co. (MMM-NYSE) do this by allowing employees to spend a portion of their time on projects of their own choosing and initiative. Investors know that success in rapidly changing industries can be fleeting without constant innovation. For example, Apple Inc.'s (AAPL-NASDAQ) stock has been volatile in recent months, having declined from an all-time high over US\$700 down to a price around US\$470. One contributing factor is the perception that there is now an imagination deficit at the company with the passing of Steve Jobs and the loss of other key members of past design teams, which could lead to less product innovation.

Theoretically at least, all investors already use reason. What investors should be doing is to add more imagination to the process. To accept that investing and business are exclusively the realm of logic and reason is to limit your own potential. As CBC's "Imagination" reminds us, no matter what we do to earn money, we are all artists, as we are all creating our existence constantly. We are improvising every moment because we have not lived it before. *"What is now proved was once only imagined."* – William Blake

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