Single Dimensional Thinking in A Prismatic World: A Multidimensional Word of Advice from An Investor in This Volatile Investing World

By Michael Yoshikami (August 2012)

Binary decision-making provides an understandable outcome; you either win or you lose. Decisive victories may be satisfying but they come at the cost of a potential decisive loss. In portfolio management strategy, utilizing this absolute path of decision-making holds significant risks that may have devastating effects in a portfolio.

Yet, in spite of the issues related to black-and-white strategy thinking, investors continue to operate as if investment decisions are merely like a sporting event rather than recognizing that investment portfolio decisions are far more important. In reality, invested assets for many are the foundation for a future that is dictated by capital values and returns. In today's investment world, variability reduction is critical in order to keep portfolios on track in times of heightened market volatility. Accomplishing this goal requires analysis with a thoughtful and measured approach.

Why is it that investors continually lean toward binary thinking when making investment decisions? And why do educated investors (as well as the uniformed) decide on strategy with less than prudent regard for what might go wrong (rather than assuming that all will go well)?

There are many reasons for this biased perspective including the following:

- Media headlines screaming a right or wrong answer that is assumed to be correct by a trusting public
- Lack of understanding that hedging strategies can provide portfolio insurance in terms of reducing market volatility
- Time frames for investment action that does not accurately reflect the investors emotional reactions (short and long term)
- Unrealistic return expectations that rely on roulette style gambling judgments without factoring in potential losses

Investment managers (as well as individual investors) often fall prey to examining issues without a detailed review of the multiple facets of the issues at play. As an example, let’s examine China as an investment opportunity.

China's rapidly growing middle class will likely continue to grow strongly over the next 10 years. Based on this assumption, one might be inclined to pour massive capital directly into China based on this compelling demographic data. By focusing only on this one factor, the investment decision is very clear and provides a simple rationale for investing in this rapidly growing country.

Now stop for a moment to consider the constraining factors that might impact China's growth. While the middle-class is rapidly expanding, does that necessarily mean that equity prices must rise? Of course not; valuations may have already been factored into a rising middle class. And what about the slowing growth rates in the United States and Europe? If your largest customers are nearly bankrupt what does that mean for your export economy? And what about real estate prices that have been bid up based on frothy speculation in many parts of China; can this continue forever? These questions are but a subset of the contra arguments for investing in China.

But, before you conclude that investing in China is a mistake, consider the positive arguments for a China investment. There are compelling arguments for direct investment into China given their surplus reserves, the previously mentioned growing middle class, business development zones attracting high wage businesses from around the world, and a government committed to stimulating the economy.

Confronted with a conflicting set of data, investors oftentimes freeze rather than sort through the information in an organized manner. It is less intellectually taxing to gravitate toward simplistic conclusions, but the easy route is not necessarily best. Rather, what is necessary is for the investor to put a process in place for analysing multiple variables.

One way around this is to employ a systematic process that in summary operates along the following principles:

- Gather positive and negative data without any preconceived conclusions; be scientific and academic as a data gatherer;
- Examine micro and macro factors within economies as well as from outside influences;
- Consider exceptional potential impactors that can skew expected results;
- Assess analyst opinions and gather positive and negative voices with an understanding that bias is at the heart of every opinion;
- Sort and organize data based on the most important impactors for the decision to be made;

- Assign a probability ranking (1 to 100) to every outcome and determine the percentage conviction level of every potential outcome;
- Develop an alternate view to every thoughtful conclusion developed.

This process provides the foundation for analysing multiple data points in a thoughtful and academic way rather than defaulting to a black and white binary decision-making process. Perhaps this method of review sounds complicated. It indeed is a complex process and far more multidimensional than a yes or no answer. After the analysis one is left with a mountain of judgments to sort through. But the end goal is just that; to gather data and opinions and thoughtfully sort through the pros and cons of each judgment.

The world seeks to reduce questions down to their most simple components. The media needs to present information in this fashion in order for readers or viewers to quickly understand the illustrated point. But recognize that focusing on a single view or data point based on one overriding factor can have massively negative results. In the world we live in today, the cost of being wrong has never been greater. The investment landscape is littered with casualties believing that the answer was obvious and that a black and white decision-making process was appropriate. The dot com crash, the social media crash, the real estate crisis… the list goes on and on of periods when investors believed that the answer was easy (and obvious) and formulated investment conclusions by merely relying on one or two facts.

Thoughtful analysis utilizing a strategy similar to the above process's use of probability judgments is a reasoned way to construct a formula in today's uncertain environment. While it may sound far too practical and conservative, there is something to be said for investing with the perspective that everything you believe can be wrong. The reality is, no matter how great the investor, everything one believes can be wrong. What 'should be' doesn't matter because market realities dictate current truth.

Don't repeat the mistakes of others. Learn from dogmatic thinking and recognize the foolishness of believing one's own opinion to the exclusion of the consideration of outside viewpoints. Investing with wisdom requires a healthy dose of humility and the recognition that other viewpoints are valid. A multifaceted examination of a problem is best in a world that is constantly morphing and one that is sure to surprise even the most sophisticated investors on a day-to-day basis.

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