

Ignorance is Not Bliss

Peter L. Bernstein

Does anybody really believe they *know* what the future holds? Nobody I have ever met. We may have judgments or may attempt to assign probabilities, but only fools assign 100% to their expected outcomes.*

Then why am I hipped on this matter?

I constantly observe a huge gap between what we claim we believe about the future and the way we act. When I remind an audience that we do *not* know the future, I see all the heads nodding affirmatively. Yet just as frequently I see people act as though they *do* know what is going to happen.

The proof of this inconsistent behavior is simple. If we really do know what the future holds, nothing would ever take us by surprise. And if we really acted as though we have no idea about what the future holds, nothing that happens would take us by surprise. But we are constantly taken by surprise, all of us. Q.E.D.

We must be acting as though we know what is going to happen, no matter how much lip service we pay to the contrary notion. This particular affliction is nothing new in human history. Except in fairy stories, surprise is an endemic feature of our lives. The opposite of surprise—stability—is a much more unstable state of nature.

Yet rational people make long-run and relatively irreversible decisions every day of the week, decisions they would not take without some conviction about what the future holds. They build factories, develop new products, acquire other companies, and hire employees. They get married, buy new homes, and produce children. Julius Caesar crossed the Rubicon. National leaders even declare war. No rational individual would do such things if the future were truly a black hole. *But it is a black hole.*

How can this be? Note that my enumeration of actions above excludes buying and selling publicly traded financial assets. The difference is critical; the distinguishing feature is control. Anyone would commit beyond the next three min-

utes if we had some control over what happens afterward. Decisions to build factories, get married, and even make war all rest on the assumption that we can adjust the opportunity set if the unexpected happens. At the new factory, we can fine-tune pricing, fire employees, or change marketing policies. Adjustments in personal relationships held together by deep affection occur all the time. And commanders-in-chief can change generals, shift strategies, and seek new alliances. None of these adjustments is guaranteed to work, but they present realistic opportunities to deal with surprise and justify the long-run decision.

Investment in publicly traded assets is different. The value of these assets depends on individuals over whom the owners of the assets have little or no direct control—corporate managers and political leaders. Investors buy these assets anyway, because most investors believe they have an exit strategy in the market itself, where they can liquidate their claims if need be. But even here investors have no control, for they cannot force the other players in the markets to pay the prices they hope to receive. Our wealth and our jobs are at the mercy of surprises.

Lack of control over outcomes explains why risk management must be the dominant tool for success in investing. The very notion of risk management is an explicit statement of ignorance about a future over which we have no control. Diversification and hedging are explicit admissions that we do not know what the future holds. You can try to be a shooting star if you choose, but the long history of markets demonstrates that the survivors are those who eschew maximization and manage their risks instead.

As an addendum, there is a new answer for owners of publicly traded assets: Pay attention to corporate governance, and vote proxies with care and attention!

*This statement implies there are no fools in my circle of acquaintance. Well, let it go.