When Numbers Cloud Meaning – The Fallacy of Investment Research Exactitude

The Importance of Coupling Narrative with Numbers to Avoid Paralysis

In 1942, Great Britain was anxious to bring the war across the English Channel. When Winston Churchill (who once said "I am easily satisfied with the very best") heard that his technical/design people were spending the bulk of their time debating the design specs of the landing craft that would deliver tanks and troops, he issued this chastisement: "The maxim: 'nothing avails but perfection' may be spelt shorter: '*Paralysis*.'"[1]

So if Churchill were a Portfolio Manager, which would he think worse – knowing promptly, in these idea-starved markets, that an investment makes sense, and then tediously waiting on or working on the numbers to support it, watching the investment work out in the interim and missing the easy money, or making the investment early without a complete data review, taking risks that something is missed in the short term?

This is a follow on piece to a white paper I wrote, *Investment Processes, Idea Generation and Human Biases*,[2] and is at the urging of some of the investment managers who've recently presented at our weekly TERP workshops.[3] These friends and I have triangulated a recurring theme: Portfolio Managers surprised by (often frustrated by) analysts over-emphasis on numerical exactitude and certainty. *Spoiler Alert*: seasoned investors know to not let a lack of financially modeled exactitude cloud the thesis and delay allocation of capital to swiftly vetted compelling ideas.

Numbers and Narrative[4] – The Road Has Changed and the Drivers Have Too

It's my view that there is an emphasis on *Numbers* (valuation) over *Narrative* (the story) today, perhaps as irrational fears associated with lack of certitude, was further hastened by the *Great Recession*. The investment management business was already enormous in 2007; its ranks teeming with newly minted analysts with uber-excel skills. Virtually none of them and none of their modeling mattered in helping their employers avoid the wholesale carnage that occurred to investment assets in 2008. Further, those that did see the prospects of a market downturn were primarily reliant, in my view, on *Narrative*.

People are even more averse to the prospect of future losses when they have experienced loss in the recent past, as most people did during the 2008 financial crisis – Richard Thaler, University of Chicago

Nonetheless, the full-on freak-out of those that remained in the business lost their mojo – that is, being blindsided by the *Great Recession* translated into heightened probabilities of *everything* we look at going wrong, every *qualitative* connection, every assumption, every macro or industry trend being simply idle speculation unless *quantitatively* corroborated. In other words: there is no perceived edge in that which was initially the

[1] Churchill note to General Ismay, December 6, 1942.
[2] *Investment Process, Idea Generation and Human Biases*, Lupoff, Shark Bites Vol 4, Article 9 August, 2014. http://nebula.wsimg.com/5c753497a6affdbdcf14a99edbe36042?AccessKeyId=ED7655C1814E263BA776&disposition=0&alloworigin=1
[3] TERP is the Tiburon Extern Research Program. Tiburon takes select Externs into this program with syllabus, model portfolio and guest speakers/lecturers run separate from the asset manager. See http://www.tiburonholdings.net/careers--tiburon-extern-research-project.html
[4] With homage to Professor Aswath Damodaran of NYU.

only edge that great investors historically had – vision, perspective, reason, experience and gut. Ironically, then, the converse is true? Investment edge is somehow the rote valuation work around publically available quantitative data? Can't machines do this?

The Case for Numbers

Source: Dilbert, Scott Adams

While it is true that rigid cash flow based models will not work with companies where promise and potential are what is driving value (not that this is typically what we are looking at), staying with just narrative exposes you to two significant risks:

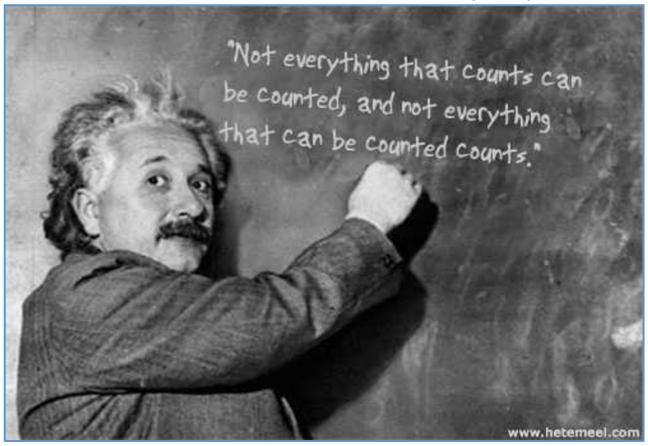
1) Without constraints, creativity can carry you to the outer realms of reason and into fantasy. While that may be an admirable quality in a painter or a writer, it is a dangerous one for an investor; and
2) When monitoring a business as an investor, you need measures of whether you are on the right path, no matter where that business is in its life cycle. When narrative alone drives valuation and investing, there are no yard sticks to use to see whether you are on track, and if not, what you/they need to do to get back on the right path.

The Case "Against" Numbers and Their Advocacy

Statistics are used much like a drunk uses a lamppost: for support, not illumination – Vin Scully

Those most (or only) comfortable with numbers believe that valuation should be about the numbers and that narratives/stories are distractions that bring in irrationalities into investing. Therefore, given the adage about to a man with a hammer, everything being a nail, models are always better when both bigger and more complex. The more line items and pages, the better. More and detail is a proxy for, and presents the illusion of precision. Mastering *Excel* is considered a critical step. The more you use numbers, the more precise you become. Further, there is the fallacy of *No Bias*. Numbers don't lie and data doesn't have an agenda. Thus, analysts focused on numbers are more likely to be unbiased… and of course this sort of work takes, well, a lot of time.

Oh What Does *He* Know Anyway?!



We are in a time and place where data is plentiful. More data is better than less – of course! This trend and belief is reinforced by the amount of data that we have available and the ease with which we can access that data. The increased stature in a time and place of the fear of being wrong, in certification, i.e., CFAs and other such designations, suggesting some level of trained valuation or investment expertise worthy of following, is an anecdotal observation offered up.

A valuation that is all Numbers and no Narrative will not draw in skeptics or convince others. It may intimidate them (may well be the analyst's reasoning and comfort). This often leads to no decision – often the decision the analyst may be driving. After all, I've done the work, the work says do nothing, so I have done my job and don't have to take any real risks of being right or wrong…nor do I need to have any vision.

The Case for Narrative

You're never going to kill storytelling, because it's built into the human plan. We come with it – Margaret Atwood

I'm not going to make the case for and against Narrative. It misses the point! No legitimate investor invests solely based upon *Narrative*. This paper is not about pitting Numbers versus Narrative. They each have their place, importance and are, as we will discuss, inextricably tied to good investment decision-making. The problem, therefore, is not Narrative-based investing to the exclusion of Numbers. It's the current markets trend toward Numbers-based investing to the exclusion of Narrative. So what drives this determined jettisoning of what can make us distinctive, what is our edge (as human investors, versus, say, algorithms,[5] etc)?

[5] I further wish to distinguish that this paper is not about human investing vs machine investing – algorithms are tools we can use to make better decisions. We are no Luddites and we are studying, via our TERP program, algorithms that can make Tiburon Capital Management, better event-driven investors.

Safety in Numbers - The Fears that Drive Over-Reliance on the Quantitative

Post-Great Recession Mojo Loss and the Aggrandizement of Numbers Geeks can be laid at the doorstep of three (3) separate forms of paralysis: 1) Analytical Process, 2) Decision Precision and/or 3) Risk Uncertainty Paralyses.

Analytical Process Paralysis

Pure Numbers (the man with the hammer) people often are apparent in their reticence to talk to the company in question, other buy-siders, sell-side analysts, well, typically, anyone. Whether it's the analyst's personality or the culture of the firm, perpetrators of *Analysis Process Paralysis* aren't likely to recognize it as a problem. Perhaps they believe they are protecting the firm from disastrous (Narrative-based) decisions. Portfolio Managers should also be aware of their contribution to *Analysis Process Paralysis* - in particular, the role that risk aversion and indecisiveness on their part plays in fostering this condition.

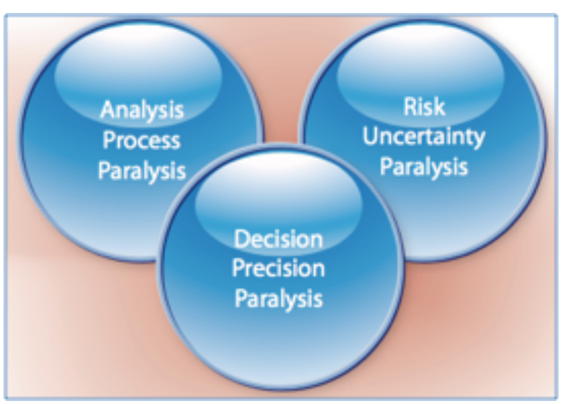
Decision Precision Paralysis

The age-old bromide that says "the more we learn, the less we know" has a role in contributing to the condition that can be identified as *Decision Precision Paralysis*. As one set of options is explored, questions and possibilities emerge that give rise to additional options that come with their own set of questions and possibilities. And so the cycle continues, if allowed.

Risk Uncertainty Paralysis

Fear of failure can be a compelling force for doing nothing or doing a lot of something that amounts to nothing. There is a common impulse that often compels those who are risk-averse to seek more from analysis than analysis is able to give - namely, the elimination of uncertainty.

The Holy Trinity of Investor Dysfunctionality Symptoms



In all three cases, the answer may be to persist in laborious number crunching until what? The investment no longer is attractive, the questions we ask lead to more questions to answer and in the end, *the research efforts are the product, not the portfolio selection*, the positions yielding results for better or worse. A basic inertia sets in where all the effort really only leads to indecisiveness, or, nothing.

Who Runs the Asylum? (The Good Old Days)

Let me take you back to the olden days for a moment. I worked for Marty Whitman of *Third Avenue Funds* from 1990-98. Arguably, Marty may be the ranking living Deep Value Practitioner-Academic. Back in those days, it was clear who and what ran the firm – Marty and *research*. But we *all* did it and those that did it well, followed Marty's approach. Marty would get a stack of 10-Ks and 10-Qs on a company, maybe read some recent and historical news items (no sell-side research), he'd talk to the company, industry professionals and others with informed points of view he respected, and decide. This was a pretty quick process. Marty expected those who worked on the investment ideas he was processing, to keep up and follow promptly. During this time I learned to review and value the balance sheet first, read notes that might give or take from value, then go to the income statement and slap a conservative multiple on earnings. For me, I did a lot of this sort of work on the subway rides home, jotting notes and calculating valuations in the margins of the documents. By morning, I'd walk into work with a valuation point of view. If we liked it, we'd invest quickly off this sort of work. Over the following week or so, one of the battery of research analysts would generate a more formal, beautiful model and presentation on the investment. Typically, valuation differed only minutely. This modus operandi worked fine – we did not fail to make investments in a timely manner, we didn't fail to ultimately corroborate valuation or uncover additional supporting data, or (rarely) data that disproved the initial thesis.

Perhaps it's a cultural change in the asset management business that Numbers have come to mean more than Narrative. As the business got bigger, as professional investors achieved wealth, fame, notoriety, there was an inexorable growth in newly minted grads, MBAs and PHDs that thought investment management was a more attractive field than medicine, law, teaching, engineering, etc. This is not the forum to debate or bemoan these facts. The point being that it used to be that professional investors (that were any good) were of a particular temperament. They loved what they did and were drawn to the business and did it well. Then asset under management skyrocketed, young professionals flocked to the business with the only real stock in trade being ever better academic credentials and modeling skills. No wonder there is such distrust among the industry throngs of *Narrative,* their skills are predominantly only in running *Numbers*.

Well at *Third Avenue* in the 90s it was clear who ran the asylum. In 2016, in this gigantic machine that is money management today, it is not so clear as increasingly there is an investment culture of CYA. Part of this is a function of the limited number of professionals with the gut and perspective to trust *Narrative* over their and the multitude of their colleagues' one-dimensional *Numbers* training. Part too, is that running so much capital makes crap returns derived from the façade of complex model-derived numbers and valuation work *good enough*.

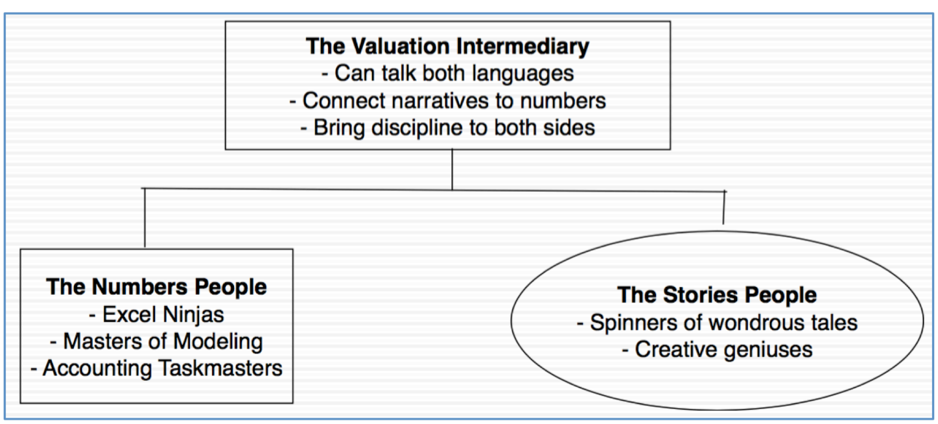
How is the Best Sausage Made?

Numbers | **Narrative plus Numbers**

Which do you Think Tastes Better?

If Numbers without Narrative is just modeling and Narrative without Numbers is story telling, the solution, as I see it, is both obvious and difficult to put into practice. In a good valuation, the Numbers are bound together by a coherent Narrative and story telling is kept grounded with Numbers. Implementing this solution does require work and I would suggest a rigorous yet dynamic methodology – ours is dubbed *BRACE*.[6]

Marrying Numbers and Narrative to Make the Best Investing Decisions



Source: Aswath Damodaran, NYU Stern School

[6] See our description on Tiburon Capital Site: http://www.tiburonholdings.net/brace-investment-methodology.html

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Summary

Harkening back to Churchill's rebuke and wording reveals that a more apt characterization of an investment decision making logjam is that: myopic dependence on numbers is not analysis paralysis, but *perfection paralysis* - the failure to act when the need for action trumps the quest for perfection. We are in the business we are in. If we are skilled, if there is an edge, it is not in the Numbers, it's in the Narrative. And it requires a firm hand to know when to take steps in advance of perfection around the Numbers.

Numbers and Narrative must be inextricably tied. Narrative, however, is the driver. It is the look out over the windshield at the road before us. The notion of a plausible *Revaluation Catalyst* can only be thought of in terms of *Narrative* as the catalysts are simply, well, *plausible*. It may or may not happen. Our conviction level about probability is a function of the collective elements of our *BRACE* Methodology, and in all circumstances, variable and qualitative. *Numbers* are the arthropod, the exoskeleton that help us avoid wasting time, that help us maximize points of entry and exit. In this way, *Numbers* and *Narrative* are both essential. You can get into trouble without a command of both, but you will never make money in event-driven without *Narrative* providing the roadmap of what's ahead. *Narrative* is forward-looking, *Numbers* are looking in that rear-view mirror.

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