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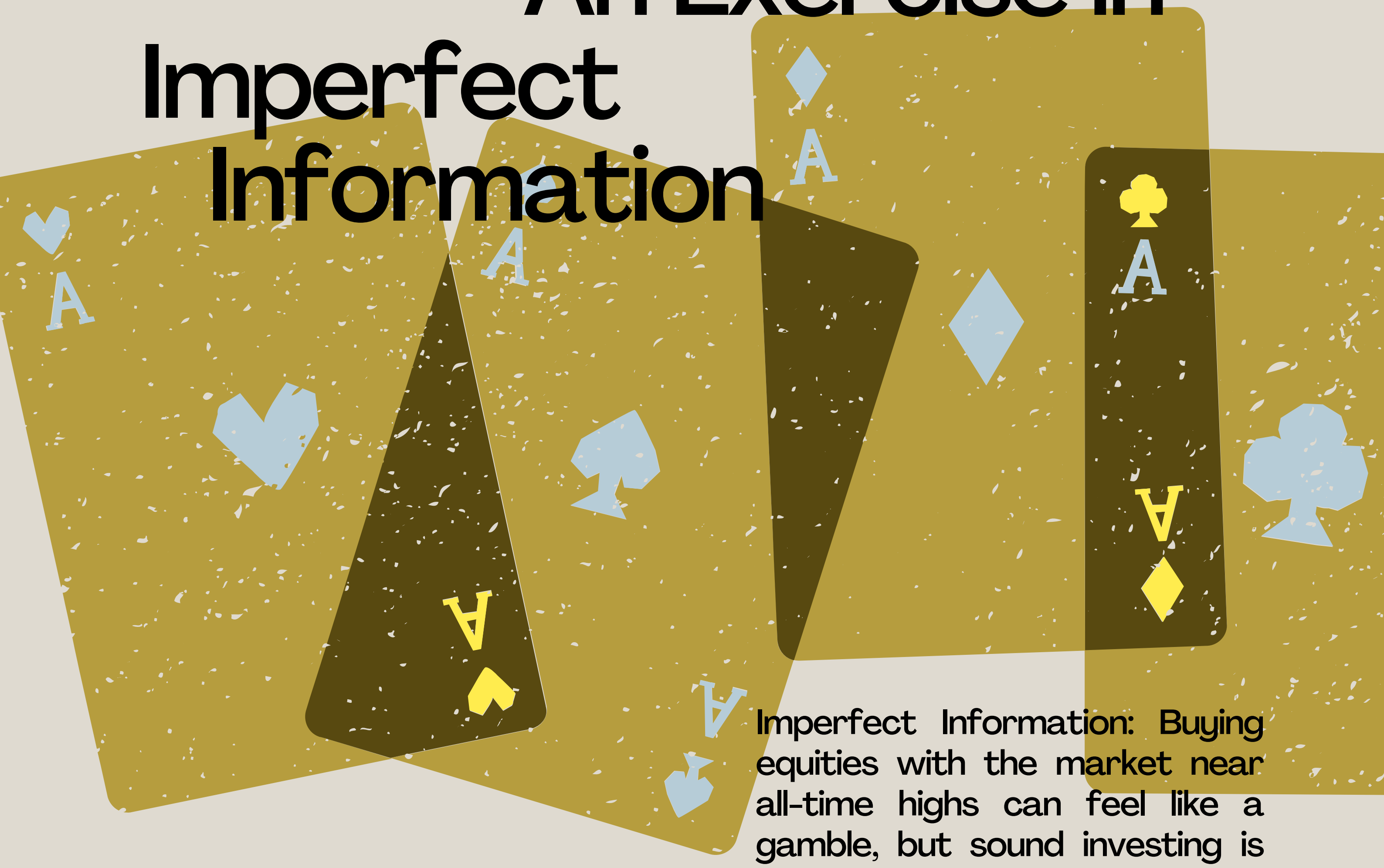
HUNTER INSIGHTS

An Exercise in Imperfect Information



Imperfect Information: Buying equities with the market near all-time highs can feel like a gamble, but sound investing is not gambling.

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Buying equities with the market near all-time highs can feel like a gamble, but sound investing is not gambling. Betting on the outcome of a coin flip is gambling. A coin has no memory. It does not remember that it just came up heads. Roulette is gambling. The fact that it just came up black does not change the odds that the next spin will also land on black. Investing without information is gambling. Just because a stock went down 5 days in a row doesn't mean the odds of it going up tomorrow have increased. While often used as a metaphor, investing is not chess either. Chess is a game of perfect information. All pieces and their positions are known. All available moves are known. This is why two computers of the same analytical strength will always draw in a game of chess.

Investing lies in the middle, an exercise in imperfect information, and may be better compared to poker. Professional poker players will tell you that they do not gamble, but play a game which fuses uncertainty with skill, conviction, and risk management. In Texas Hold'em, you know the two cards in your hand to start. Then, one by one, you are exposed to the five face up cards on the table. While you don't know which cards are in other players' hands and which are still in the deck, you can make inferences and decisions based on the action and play of others in the game. If an ace is showing, the probability of aces elsewhere has now changed. Dependent probabilities also exist with investing. We know the public information provided by companies in earnings reports and SEC filings. We then assign probabilities to various outcomes, looking for opportunities that outweigh potential risks both quantitatively and qualitatively.

A key skill for both investors and poker players alike is managing variance (or "bad luck" as most would call it). Variance is the probability in which a negative outcome will occur when you are favored to win. Having a pair of aces is the best starting hand in poker. Still, it will lose roughly 15% of the time to a random hand. That 15% is variance. Losing with aces three times in a row? That is an unlikely scenario, but statistically it will happen. Investment variance can be anything from a black swan event (a global pandemic) to a company specific concern (unforeseen component shortage). Poker players handle variance through bankroll management (tailoring bet sizes to probabilities) while investors manage variance through diversification and position sizing.

Imperfect information certainly contributes to variance, but it can also contribute to outperformance. The largest companies in the investment universe receive a great deal of attention, analysis, and news coverage, with dozens of analysts tracking their every move. In contrast, smaller companies are not followed as closely, and while this lack of coverage can create the potential for additional variance, it can also create opportunities. In no circumstance is information about a company perfect, but the market is less efficient with less information. This information gap is part of the reason we focus a great deal of our efforts on underfollowed companies, searching for value where few others are looking.

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