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focus

This year has been another sharp reminder that investing means embracing uncertainty. When you make any investment — whether in stocks, bonds, property, or your own education — you are doing so on the expectation of future benefits. However, no matter how much in-depth research you've undertaken you can't fully protect yourself against one key thing — the inherent uncertainty of the world in which we live.

FORSYTH BARR

> *"Prediction is very difficult, especially if it's about the future."*

ATTRIBUTED TO NIELS BOHR (PHYSICIST) ... MARK TWAIN (AUTHOR) ... AND YOGI BERRA (BASEBALL PLAYER AND PHILOSOPHER)

> *"There are two kinds of forecasters: those who don't know, and those who don't know they don't know."*

JOHN KENNETH GALBRAITH (ECONOMIST, DIPLOMAT)

It has been extraordinary just how unpredictable and volatile the world has been over the past few years. We've had COVID, the first global pandemic in over a century. The shutdown of the global economy. Fortunately, followed by the development of vaccines at record speed. The lowest interest rates in human history. Central banks printing huge sums of money (literally creating money out of thin air). The highest inflation in decades. Which then fuelled rapid interest rate rises. A boom and then crash in house prices. Bank failures. Crypto crashes. Extreme weather events. The first major war in Europe since World War II. It's hardly surprising that markets have been volatile.

Hindsight is 20/20

One surprising trait of humans is how well we generally take all this volatility and uncertainty in our stride. In fact, after the event we often view it as having been somewhat predictable. This cognitive bias, known as the hindsight bias (or the "knew-it-all-along" effect), makes events seem more foreseeable after the fact. It is why people, in retrospect, don't feel like surprising events were actually all that surprising.

Psychologists give a range of reasons for our hindsight bias:

- **Cognitive simplicity:** Humans are inherently good at storytelling and like to construct narratives that make sense. After the fact events are simplified. The complex web of circumstances, variables, and probabilities are compressed into a straightforward cause-and-effect chain in our minds.
- **Confirmation bias:** Once we know the outcome, our brains focus on the information we now know to be true while ignoring data that doesn't fit, which makes the event seem more inevitable than it actually was.
- **Ego protection:** Believing that we "knew it would happen" provides psychological comfort and make us feel smarter and more in control.

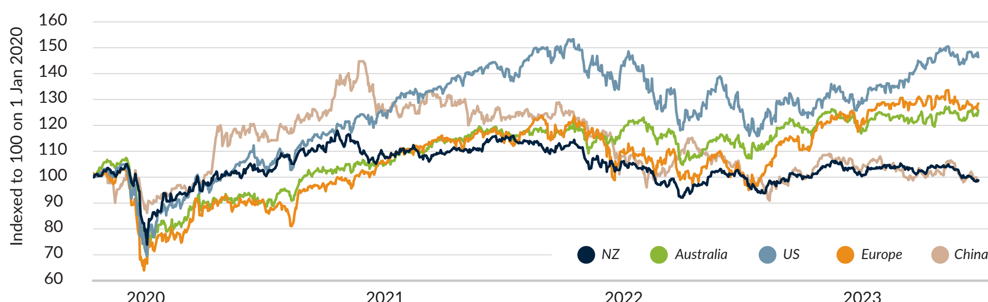
One challenge of the hindsight bias is it clouds our realisation of how uncertain the world actually is. Daniel Kahneman, one of the fathers of behavioural economics and Nobel Prize winner in economics, recognised "our tendency to construct and believe coherent narratives of the past makes it difficult for us to accept the limits of our forecasting ability". Put simply, the world is a lot more uncertain than most people appreciate.

2023 has been another eventful (and unpredictable) year

Uncertainty, extreme events, and market volatility have continued through 2023.

It was just under a year ago that global stock markets troughed. At that time predictions for the global and the US (the world's largest) economy were generally glum. The vast majority of economists were predicting a sharp recession. In September last year Bloomberg's economic models put the chance of US recession at 100%, i.e. a cast-iron guarantee. But **what was described "as the most anticipated recession in history" hasn't happened.** US consumers and the jobs market have remained resilient, the US housing market has stabilised, while fiscal policies to promote things such as renewable energy and semiconductor production have provided a boost.

THE SHARE MARKET ROLLERCOASTER



Source: Refinitiv, Forsyth Barr analysis

> **...the list of major global climatic events this year is long — heatwaves across Europe, Asia, and parts of North America...**

One factor that was expected to help the global economy this year was China's reopening after the surprise scrapping of its zero-COVID policies near the end of 2022. However, despite the optimism **the Chinese economy has disappointed.** The biggest challenge is housing — t**he Chinese property bubble has burst.** For decades, much of China's economic growth has been built on the increasing urbanisation of its 1.4 billion population and the massive boom in construction of housing and infrastructure. Now, however, the imbalances are biting: extreme overinflated house prices, tens of millions of empty homes, developers struggling to meet debt payments, and a declining population. Looking forward, China won't be the same driver of growth that it has been over the past couple of decades.

Weather is always unpredictable but the number of extreme events is rapidly rising — it's hard to argue nowadays that climate change isn't having an impact. Early this year New Zealand was hit by the Auckland floods and Cyclone Gabrielle. July was the hottest month on record globally. And the list of major global climatic events this year is long — heatwaves across Europe, Asia, and parts of North America, wild fires in Hawaii and Canada, floods in Pakistan, India, and more recently Libya, just to name a few. There is little doubt that initiatives to counter and mitigate the effects of climate change will be a growing global focus (and provide investment opportunities) in the years ahead.

Probably **the biggest revelation for markets this year has been the break out of artificial intelligence (AI).** While AI technologies have been evolving in the background for decades, the release of ChatGPT and large language models has grabbed the public's (and market's) attention.

Today, much of the focus is on companies which supply the processing power to train and power AI technologies, along with a few that have released early AI-based applications. In the years ahead AI will be a transformative force for businesses and the broader economy. Like any new technology there will be winners (including companies we haven't yet heard of), while others will see their business models disrupted by new or greater competition, or even made obsolete.

Another new technology which has impacted markets this year is obesity drugs. Discovery of these drugs was actually an accident — researchers found that exposing the brain to higher levels of a natural hormone promoted weight loss ... and they don't know why, or if there'll be any long-term effects. Despite these unknowns, the hype around these new treatments has been huge. Danish company Novo Nordisk, which makes two of the obesity drugs, Ozempic and Wegovy, recently overtook luxury good conglomerate LVMH as Europe's biggest company by market capitalisation. Values of some other healthcare companies have fallen as investors ponder whether these new drugs will mean less prevalence of other conditions, such as diabetes, heart disease, or sleep apnea.

Technologies such as CRISPR-Cas9 for gene editing and mRNA which was used to develop some COVID vaccines has created optimism for a pending wave of new breakthrough medical technologies. AI has added to that optimism, with hope it can help across many areas such as imaging, diagnosis of diseases, and accelerated drug discovery and testing. Potentially we're entering a "golden age of medicine".

...embracing uncertainty doesn't mean taking unmitigated risk...

Embrace, but manage, uncertainty

It'd be understandable for anybody to ask, "with all this uncertainty, how am I meant to manage my investment portfolio? How am I going to get it right all, or even most, of the time?"

The comforting news is you can't. No one can. Investing is influenced by an infinite number of variables that are impossible for any person to digest. The other comforting news is that uncertainty is not always negative — bearing this risk is why investors in shares earn higher returns over the long-term than more certain investments such as bank deposits. The key is not to eliminate uncertainty, but to manage it effectively.

How do you do that? Overconfidence is your enemy. As Mark Twain said: **"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so".**

The oldest advice in the book is diversification (not putting all your eggs in one basket). Diversification means holding different types of assets across a range of geographies and industries. A long-term focus is also key, recognising that ups and downs along the way are part of the journey.

A diversified portfolio should rise with the tide of human progress over time. You won't get all the winners. You'll get some. Unfortunately, you'll also have some losers. The aim is to keep these to a minimum, but don't punish yourself when they (inevitably) happen.

Minimising the losers means avoiding the hype. Unfortunately, most investors' returns are significantly worse than the overall market. Why? Because of their costly tendency to chase the "exciting" new companies and industries. If an investment is en vogue you should approach it with a higher level of caution. If everyone "knows" it's a good investment then there's a high chance an overly optimistic outlook is already priced in.

Embracing uncertainty doesn't mean taking unmitigated risk. But it does mean being comfortable with uncertainty — it's a prerequisite for investing.

Matt Henry CFA
Head of Wealth Management Research

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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