

A Framework for Decision Making

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On the surface, science and investigative journalism appear to have nothing in common with investing since the two professions have nothing interesting to say about economics or a company's business model. However, science and investigative journalism have a framework that helps in decision making which is very important in investing.

The scientific method is all about hypothesis testing. You start with a guess about how something works and then carry out experiments to prove your initial guess. More importantly, you try to disprove your initial guess. This second point is especially important in investing because if you find an investment you think is good, you will be biased to find evidence supporting your initial guess that the idea is indeed good. Searching for disconfirming evidence is a good way to overcome this bias. Changing your mind based on new evidence is how to do good science and is equally important in investing.

The main job of an investigative journalist is to carry out research, ask the right questions and follow the evidence wherever it may lead whilst being acutely aware of any biases that can influence the answers they find.

Applying the skills of an investigative journalist to investing was popularised by Philip Fisher, Warren Buffett and Peter Lynch. They would talk to customers, employees and competitors about a company they were researching.

These investors didn't spend too much time talking to a company's management because they understood the biases at play – a company's management is incentivised to tell you what you want to hear. What is a universal truth about every company that has ended up in the corporate abyss of bankruptcy? Their management teams all had a plan for avoiding bankruptcy and were willing to tell anyone who would listen about their optimistic plans.

At Tacit, we don't spend too much time interviewing fund managers. Instead, we look at how they have made decisions in the past as a guide to how they will make decisions in the future. How do we do this? Reading any books or annual letters they have written and searching for past interviews where they discuss their process in depth is a good start. Ultimately, we are looking for consistency – a match between their stated process and how they actually make decisions.

Quantitatively, we also look at how those returns were generated to spot managers with consistent and predictable investment styles using a multiple linear regression model. This is simply a statistical method used to understand the variables that influence a fund's long-term return.

A combination of the scientific method and investigative journalism gives a good framework for making decisions and finding good investment ideas.

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