

Known Unknowns and Share Prices

Ambiguity aversion sucks.

In February of 2002, Donald Rumsfeld famously introduced known knowns, known unknowns, and unknown unknowns into the lexicon. To complete the permutations, we're going to add another one here; unknown knowns.

In the investing community, known knowns are priced in. Unknown unknowns aren't. They can't be. Unknown knowns are when people ignore information in front of their face. This is confirmation bias. That leaves known unknowns; and man, do investors not like known unknowns. Investors don't like ambiguity.

Undefined regulatory risk? Undetermined litigation liabilities? Uncertain debt refinancing? These all make Mr. Market panic, and it is where loss aversion creeps in. Actually, the *fear* of loss aversion creeps in.

Thanks to Daniel Kahneman and Amos Tversky, we all know that losses feel a lot worse than gains feel good, and that it fuels and affects our decision making. We think this is not just relevant for losses that we have already sustained, but for future losses that we think are likely.



Capitalising on Ambiguity Aversion?

When we know that there will be bad news coming, we brace for the impact. But when we don't know precisely how bad things will be, we do more than brace. We panic. We scatter. We run for the hills.

It may actually be that the expectation of bad news weighs more heavily on our psyche than the actual bad news when it arrives; even if the extent of the bad news confirms our worst fears.

This isn't just a thing for investors. It happens to everyone. The impact of waiting for test results (whether for medical tests or SATs) can be more stressful than the actual results, even if they are as bad as we expected. Guy Montgomerie, a psychologist at the Mount Sinai School of Medicine suggests "many people try to inoculate themselves by imagining the worst."¹ A group of neurologists from UCL and King's College² suggest that there is a "strong relationship between stress and....irreducible uncertainty."³ Psychologists have suggested⁴ that for those with particular psychological traits, waiting for the results of genetic tests can motivate adverse (sometimes severe) psychological risks.⁵

So why wouldn't the stress of waiting for bad news affect Mr. Market adversely too?

Of course it does.

Does Mr. Market often imagine the worst? We think he might. And when he imagines the worst, does he suffer from loss aversion and imagine pain that is twice as bad as it really will be? Maybe. Has this featured in the behaviour of some equities historically? We think so. BP in July 2010? VW in September 2015? Both ended up getting some pretty bad news, as bad as the biggest bears imagined. But the bad news was overbaked. Once that temporarily "irreducible uncertainty" was reduced - once it became a known known - the ambiguity aversion vanished. And the stocks subsequently recovered from the overreaction.

And the great thing about ambiguity aversion, is that it eventually recedes. It eventually goes away.

¹ <https://well.blogs.nytimes.com/2012/07/23/the-anxiety-of-waiting-for-test-results/>

² de Berker, A. O. et al. Computations of uncertainty mediate acute stress responses in humans. *Nat. Commun.* 7:10996 doi: 10.1038/ncomms10996 (2016)

³ <https://www.nature.com/articles/ncomms10996>

⁴ Lerman, C., Croyle, R. T., Tercyak, K. P., & Hamann, H. (2002). Genetic testing: Psychological aspects and implications. *Journal of Consulting and Clinical Psychology*, 70(3), 784-797.

⁵ <https://psycnet.apa.org/record/2002-01415-022>

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