

The limits of intuition

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Human brains have been wired through years of evolution to think intuitively. This fast, emotional and automatic way of thinking was useful for our ancestors in navigating the Savannah of East Africa and escaping lions. If a lion was chasing you, spending too much time deliberating whether it is friendly or not wouldn't end well for you. While this type of rapid thinking is useful in making snap judgements in our day to day lives, it can have bad outcomes in investing.

For most people, understanding probabilities is not intuitive. In investing, a poor understanding of probabilities combined with confident forecasters and their legions of analysts and algorithms can be a recipe for disaster. People are certainly attracted to this kind of strategy because confidence is often confused with knowledge. Having lots of analysts making precise forecast about a company's earning or macroeconomic forecasts is false precision, again confusing confidence with knowledge. The problem with these strategies is that no amount of PhD analysts and supercomputers will lead to good investment decisions if the inputs are bad. Garbage in always equals garbage out.

To understand the limits of intuition, consider this. Imagine you have a child who wants to be an actor. He is really passionate about it, takes part in school plays and everyone says he will be a good actor. As he grows older, every casting agent he meets says he is very talented and his chances of making it to the big screen are 95%. This seems like fantastically good odds especially because professional casting agents have seen lots of talent over the years and they have been wrong only 5% of the time i.e. 95% accurate.

Intuitively, his odds of making it as an actor are 95%. Even if the casting agents are a bit off for whatever reason, it seems likely that his odds are, at the very least more than 50% i.e. he is more likely than not, to end up being an actor.

The actual probabilities are, unfortunately, much lower. In the USA – the world capital for movies and TV, there are [160 million people](#) in the labour force and only about [30 thousand full-time actors](#). Actors only make up 0.02% of the population so the prior probability of anyone becoming an actor is only 0.02%. Therefore, the actual probability of this child being an actor (without detailing the math) is only 0.4% – much better than the average person but still remarkably lower than 95% chance given by the casting agent.

While his odds of being an actor are much slimmer than our intuitions would admit, this is not to say that every decision in life should be brutally calculated based on the odds of success. Taking chances and having a good time are also important.

In investing, taking chances and having a good time is a bad approach. Preserving and growing capital in real terms requires a good understanding of the prior probabilities to make better informed decisions.

At Tacit, our understanding of the prior probabilities comes from years of investing experience combined with a good understanding of the limits of human intuition. This will help guide our decision making, as it has done in the past, in navigating uncertainty and complex market cycles.

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