What can an investor learn from a football coach?

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The solvency of many pension schemes is improving as the real rate increases. But this does not mean we are out of the woods. The world is simply uncertain and if we want to survive the next crisis, we must begin to prepare for it today using scenario analysis. This will make us adaptive should something unexpected happen. Since the economy is as unpredictable as a football game, this is not very different from what football coaches do when preparing for a game. The coach practices different scenarios with the team so that players can be adaptive during the game.

Uncertain and unpredictable

The recent past has taught us that putting all our faith in the idea that things tend to even out and return to 'normal' can lead to serious consequences. A good way to illustrate this is to use the world's most famous sport as an analogy. The game of football is simple and is based on straightforward, enforceable rules. The pitch is well-defined and the length of a match is 90 minutes. There are 22 players on the pitch, all with the aim of winning the match for their team. Despite the simplicity of football, it is almost impossible to make consistently accurate predictions about the score. In fact, we enjoy watching a match because the outcome is unpredictable.

Headbutted

There are many variables that can alter how a match unfolds, one of them being the interaction between the players. A famous example is when Zidane lost his temper and headbutted Materazzi in the 2006 World Cup final. A human, but irrational action. The Frenchman was shown a red card, and this changed the course of the match. Knowing the players and their past performances will not help you make an accurate prediction. As any football fan knows, understanding past performances is simply not enough to predict the future. Our prediction skills don't improve with more sports statistics.

Market reflexivity

If it is hard to predict the scores of a football match, in which only 22 people interact with each other, how can we possibly expect to predict how economies will evolve, with 7 billion of us on this planet? In the world economy, billions of individuals interact and make emotional choices which affect economic development. What makes it complex is that the expectations of investors affect the market, which in turn affects the expectations of investors. In other words, it is a two-way street.

Academics describe this as the ‘feedback effect’ and George Soros calls it ‘market reflexivity’. The tech crisis of 2001 and the housing market crisis of 2007 are both examples of market reflexivity going astray, as the feedback loop becomes self-perpetuating.

Shockwaves

But expectations are not the sole ingredient for creating crises. There are many other factors that make the world complex. We are used to experiencing stable periods followed by quick shifts. This phenomenon is often explained by interconnectivity in the world through different networks. The financial markets are an extreme example of this. The more interconnected the market is, the more fragile it is to shocks. As we saw with Lehman Brothers during the financial crisis, a shock to a single investment bank can amplify and send shockwaves throughout the financial system. Investors experienced that many financial assets were not as independent as assumed. Apart from expectations and interconnectivity, there are also other ingredients for crises. Debt levels, government regulation, technological progress (or lack thereof), together with a host of other factors, all play a role. Even if the world economy seems stable over time, it will never be perfectly balanced.

A feeling of déjà-vu

Despite the lack of predictability, there are many recognisable patterns in a football match. In set plays, such as corners and penalties, the players take on familiar roles. Sometimes, the interactions on the pitch give frequent spectators a sense of déjà-vu. Remembering similar events from previous matches can give us an idea or a feeling of what will happen next on the pitch.

In economics, a recurring pattern is the business cycle. Fundamental drivers of asset prices, such as inflation and growth, take on expected roles as the economy moves from peak to trough and vice versa. Herding behaviour and investor sentiment can also lead to broad movements in prices across markets. While exact predictability of economic variables and market prices is impossible, some recurring economic patterns give us a feeling of déjà-vu, which will help the investor.

Adaptive investing

Investment strategies need to take into account both economic unpredictability and recurring patterns. Developing robust strategies that perform well under different market environments is a good start. An adaptive investment strategy means taking different patterns in the business cycle into account. This is how investors can better navigate an uncertain world. In addition to business cycle patterns, we are occasionally faced with financial crises, which deliver larger shocks to the economy. To navigate this world, investors must be adaptive and understand that the pattern might resemble the past, but will never be exactly the same. As Mark Twain said, “History doesn’t repeat itself, but it surely rhymes”.

Adjusting the strategy

A football coach is continuously faced with uncertainty. His or her job is to come up with a strategy for defeating the opposing team. To prepare, the coach analyses different potential strategies that opponents might follow before outlining his or her own strategy for the team. Every coach knows that the strategy needs to be adjusted once the opponent’s is revealed. Before the match, the coach goes through alternative scenarios with the team, so they can quickly adapt as the match evolves. During the match, unpredictable scenarios, such as a red card or an injury, can unfold. These situations require strategic adjustments. Being able to adapt to the volatile environment is paramount to winning the game.

Developing Scenarios

As investors, we cannot predict how the financial markets will develop in the future. Consequently, we need to construct a set of scenarios that are based on different variations of fundamental economic drivers. We not only need to include diverse assets, but diverse economic theories as well. Diversity will help us not to discard possible events that do not fit with specific theories. Therefore, it is important for investors to plan responses to different economic developments ahead of time, so if one were to materialise, the investor can quickly adapt to the new environment.

Follow the coach

There are different ways to deal with uncertainty, but the good solutions have one thing in common: diversity. If we want to be able to weather different economic environments, we need to fundamentally change the way we invest and deal with economic uncertainty. A good first step is to stop thinking of the economy as a perfect, self-correcting machine, guided by an invisible hand. Instead, we should think of it as a football match and approach it in the same way as a coach. After all, the economy is as unpredictable as a football game.