The AMBACHTSHEER Letter
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MAKING GOOD DECISIONS IN A RADICALLY UNCERTAIN WORLD:

THE CASE OF *COVID-19*

*"We have chosen to replace the distinction between risk and uncertainty deployed by Knight and Keynes with the distinction between **resolvable** and **radical** uncertainty. The former can be represented by a known probability distribution of outcomes…..the latter has many dimensions: obscurity, ignorance, vagueness, ambiguity, a lack of information…..".*

"For both Knight and Keynes, recognition of the pervasive nature of radical uncertainty was essential to understanding how a capitalist economy works…..but they lost the battle to put radical uncertainty at the heart of economic analysis…so instead, organizations are run with reliance on models which claim knowledge of the future that we do not have….".

"Three main propositions run through this book: 1. The world of economics, business, and finance is not governed by unchanging scientific laws, 2. Individuals cannot, and do not 'optimize', and 3. Humans are social animals and frame their thinking in terms of narratives."

John Kay and Mervyn King
From their new book "Radical Uncertainty"

Radical Uncertainty and *COVID-19*

That a book titled *RADICAL UNCERTAINTY* would be released at a time when the 'out-of-the-blue' *COVID-19* virus continues to spread ominously around the world is surely ironic[i]. It is hard to conceive of a better example of the Kay/King (K/K) assertion that the world does not unfold according to "known probability distributions of outcomes" with logical decisions made through "mathematical reasoning". The opening chapters of the K/K book make it clear the authors question the credibility of strategic decision processes based on these 'scientific' foundations.

And they are not alone of course. They follow in the footsteps of two of the greatest economists of the 20th Century, Frank Knight and John Maynard Keynes. Both emphasized the connection between uncertainty and creativity. In his famous 1921 book "Risk, Uncertainty, and Profit" Knight argued that if the probability distribution of a risky venture is known, bad outcomes can be insured against. When they are not known, good judgement is required….an unequally-distributed 'asset'. It is this 'asset' that drives value-creation in capitalist societies. Keynes put it this way in his "General Theory" (1936): "If the animal spirits are dimmed and spontaneous optimism falters, leaving us to depend on nothing but mathematical expectations, enterprise will fade and die".

Our own thinking has evolved very much along these same lines. Far too often in the world of organizations, questionable statistical processes and mathematical reasoning have replaced creative ‘animal spirits’ and good judgement in how strategic decisions under radical uncertainty are made. The ‘out-of-the-blue’ *COVID-19* pandemic is a stark reminder of this ‘good judgement’ imperative.

So how do we make good decisions in a radically uncertain world? K/K believe it should start by constructing a ‘reference narrative’ which reflects our realistic expectations, and has the properties of robustness and resilience. It is based on a thorough, thoughtful answer to the question ‘what is going on here’? Such a framing logically leads to a realistic, useful definition of risk: *“It is failure of the reference narrative, derived from realistic expectations, to unfold as envisaged”.*

A ‘Reference Narrative’ for *COVID-19*

While this approach may sound trivial and simplistic, K/K argue it is not. Experience shows that people with strong prior opinions often make bad decisions. Good decisionmakers listen respectfully, seek a wide range of opinions, form a preliminary ‘reference narrative’, invite challenges to that preliminary version, and end up with a final version that is multi-layered, pluralist, eclectic, and ‘thick’. In the world of medicine, this might be called a professional diagnosis. In the world of law, it reflects the IRAC process: Issue -> Rule -> Analysis -> Conclusion.

And why is the narrative form so important? Because a coherent, credible narrative helps us make sense of a complex and confusing world. To make this point, K/K quote behavioral economist and Nobel Laureate Daniel Kahneman: *“No one ever made a decision based on a number. They need a story.”*

Based on current information, here is my story for *COVID-19*. It starts by answering the question ‘what is going on here?’.

The medical answer is based on Alanna Shaikh’s TED talk on the topic (6M views and counting). She is a well-published expert on global health systems:

- *COVID-19* is the 7th corona virus that originated in animals, was transmitted to people, who in turn transmitted it to other people. The virus attacks the lungs with symptoms being coughs, fevers, and viral pneumonia (earlier corona virus outbreaks included SARS and MERS). The medical impact ranges from mild for most people to more severe for a minority (20% hospitalization, 3% fatal).
- These viral outbreaks will almost certainly continue due to *climate change* and the steady push of wildlife into shrinking remote spaces, thus increasing the likelihood of wildlife-human contact.
- Isolation will always be a second-best mitigation option against viral infections as many infected people show no symptoms and hence escape early identification. As importantly, extended people isolation has material psychological and economic consequences.
- The best option is to build integrated health care systems around the world capable of identifying and mitigating global health threats before they become pandemics. Such systems have enough redundancy in them to deal with peak demands for medical services and equipment. Singapore’s healthcare system is often held up as an example.[ii]
- Back to *COVID-19*, the outbreak is likely to get worse before it gets better. Better information through extensive systematic testing is critical. Persistent declines in the number of new cases will signal the beginning of the end. However, the possibility of second waves of mutations cannot be ruled out.
- Vaccines are being developed but are many months away.

Realistically, progress on the medical side of *COVID-19* will require on-going monitoring. There is also the economic side. What is happening there is as momentous as on the medical side:

- The size of the economic impact of *COVID-19* will be unprecedented in modern times of peace. The levels of GDP, employment, and corporate profits will all drop precipitously in Q1, Q2 and likely further in Q3.
- The service sectors of national economies (e.g., retail, hospitality, entertainment, transportation) will be hardest hit, reaching deeply into the medium and small business sectors where the largest proportions of national workforces are employed (e.g., 86% in the USA).
- Sustaining economic life during this multi-month free-fall in economic activity will require unprecedented levels of financial support from governments and their central banks. Most governments seem to understand this, with the "whatever it takes" promise made with rising frequency and determination. There is also an increasing understanding that this means putting money in people's pockets quickly, either directly or through their employers.
- This rapid sequence of economic events raises an important question: how should these massive levels of economic support to individuals and businesses be financed? For a long time, the conventional wisdom was through taxation and/or government bond issuance in public markets. The 'quantitative easing' (QE) activities of central banks during the Global Financial Crisis opened up a new channel: expanding the money supply through central bank bond purchases. This kind of activity by central banks is about to go into high gear to finance the current 'whatever it takes' promises by national governments. Though unintended, this puts the claims of a small group of economists promoting Modern Monetary Theory (MMT) to the test. They assert that funding government expenditures through the creation of new money is appropriate as long as governments ensure it doesn't create price inflation.[iii] In the face of considerable scepticism, we are about to discover the merits of MMT in action through the rest of 2020 and beyond.
- And then there are the financial markets, especially stock markets. In a recent blog, Woody Brock reminded us of the Pricing Model Uncertainty (PMU) hypothesis which predicts stock market volatility is driven by the level of PMU in the marketplace. Not surprisingly, with PMU through the roof today, so is stock market volatility.[iv] That volatility will not recede until PMU declines, which won't happen until we get more visibility on the duration of the medical side of the *COVID-19* crisis. However, once that higher degree of visibility arrives, stock prices should rise as equity risk premiums fall.[v]
- The current laser focus on *COVID-19* has pushed other important issues facing humanity into the background, for example, *climate change*. Despite lower visibility, slower speed, and greater complexity, its threat to global health and financial well-being may ultimately be greater than the current *COVID-19* crisis and its possible successors.

So if that is what is going on out there, how might we craft a 'reference narrative' today reflecting actions and realistic expectations about the *COVID-19* crisis from an asset owner perspective? How about this:

> *The COVID-19 virus will continue to have major negative medical and economic impacts around the world for the rest of 2020 ….and possibly longer. Longer term risk of recurrence is best mitigated through strengthening healthcare systems around the world. Greater degrees of redundancy and resilience are required. COVID-19's material negative economic impact is being matched by*

unprecedented financial support for individuals and businesses by governments and their central banks around the world. These efforts will require rewriting the playbook on government finance. Much of the funding will likely come from the unique ability of governments to create new money through their central banks by buying new government debt. Governments should make clear that such funding strategies are only appropriate under extenuating circumstances such as the current COVID-19 crisis and should end when they are no longer needed. Once the COVID-19 risk impact is seen to be receding, stock prices should rise from current levels to reflect that receding risk. Also, it is important that other critical issues such as climate change quickly reappear on the radar screens of public sector and private sector decision makers as the medical and economic urgency of COVID-19 recedes.

A final thought. Reflecting on the Russian revolution a century ago, its leader Vladimir Lenin observed: *"There are decades when nothing happens……and weeks when decades happen."* What we decide to do about the *COVID-19* crisis in the weeks and months ahead may once again set the course for humanity in the decades to come. May we decide wisely.[vi]

Keith Ambachtsheer

Endnotes:

i. *Not quite out-of-the-blue……Bill Gates warned of the possibility of a new pandemic in a* ***2015 TED talk****.*

ii. *Singapore is often held up as an example of managing an effective integrated health-care system. It has a Disease Outbreak Response System (DORS) that assesses potential diseases for arrival timing, impact potential, and appropriate response protocols. Its DORS is helping Singapore achieve one of the best COVID-19 survival outcomes in the world.*

iii. *For more on MMT, see Willem Buiter (2020), "****The Helicopters are Coming****" published by Project Syndicate. Its essence is that governments with central banks have very flexible policy space unencumbered by hard fiscal constraints. They are always solvent, which is a critically important attribute in today's crisis environment. The controversy is about their ability to use that policy space wisely. For example, there will be a temptation to continue to create new money even when the economy is at full employment, thus creating inflation rather than new economic activity. As another example, governments could use the new money-creation capability of their central banks to nationalize companies or even industries. If MMT goes more mainstream because of COVID-19, creating political constraint to prevent such abuses will become essential.*

iv. *Woody Brock is the President of Strategic Economic Decisions,* ***www.SEDinc.com****.*

v. *For example, the KPA pension fund had a dividend yield of 4.8% at the end of December 2019 and 6.2% at the end of March 2020, reflecting a 23% drop in fund market value. As dividend-paying sustainability was a key security selection criterion, dividend cuts over the course of 2020 should be modest, leaving a generous risk premium versus a risk-free real bond yield of zero. Logically, when earnings visibility returns, much of the Q1 market value drop in stocks should be reversed.*

vi. *For an especially thoughtful exposition on deciding wisely in addressing the COVID-19 challenges, see James Breiding (2020), "****'Me' vs 'We'****", Swissmade Foundation.*

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