Strategist's Corner
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Strategic Preparation

The Key to Navigating Investment Uncertainties and Cognitive Biases

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In brief

- Successful investing requires thorough preparation and involves a deep understanding of businesses and their fundamental drivers of returns.
- Cognitive biases such as confirmation bias, herd mentality, loss aversion and anchoring bias can create significant blind spots for investors, affecting their decision-making processes and potentially leading to misjudgments about asset correlations and market signals.
- Both equity and debt investments are claims on the same underlying assets of a company and understanding their relationship and potential correlations is crucial. Prepared investors must recognize these connections and potential blind spots, using comprehensive stress-testing and inter-disciplinary collaboration to navigate uncertainties in the market.

Investing is hard, but over time, great investors have shown there are ways to be successful. While academia and proponents of passive investing may classify their outperformance as luck, famed scientist Louis Pasteur said, "Chance favors only the prepared mind."

From an investment perspective, preparation comes in the form of deeply understanding businesses and their fundamental drivers of returns. This groundwork includes accumulating historical data on every aspect of the enterprise and its industry, such as the price elasticity of its goods in varying economic scenarios, how and where the product is made, their associated cost risks, and stressing the balance sheet against worst case scenarios. This culminates in assumptions about the ranges of potential cash flow outcomes over time compared with what equity and credit markets have priced.

However, history shows it's often the thing that investors never consider that derails the most well-thought-out expectations about the future. While trying to know what you don't know is hard enough, it's made more difficult when cognitive biases create blind spots.

With investing, some of the most pervasive biases are confirmation bias, herd mentality and loss aversion. However, anchoring bias, which refers to a tendency to overvalue early data when weighing future decisions, may soon have relevance to owners of corporate credits and their expectations about the future.

Legal claims on the same asset

Investors think about stocks and corporate bonds very differently given their different payoffs, which makes sense. Equity represents ownership, and thus stock values are determined by what investors believe is the present worth of future profits plus the liquidation value of tangible and intangible assets. Bonds are contracts representing capital that has been lent with a promise of return at a certain date, a series of stated interest payments, and legal claims that are senior to equity holders in the event of an adverse financial outcome for the business.

I've always liked thinking about equity as a call option on the assets and the potential returns-on-capital of an enterprise and the debt as selling a put option on those assets to the equity holders. While the strike prices are different and affected by many factors such as time to expiration, they are comprised of the same core inputs: volatility or riskiness of the business, short- and long-term liabilities, the operating and financial skill of the management team, intellectual property, tangible assets, etc.

Anchoring bias at work

The inflation shock of 2022 drove a massive spike in correlation between stocks and bonds. Since then, I've read and heard arguments that this relationship will "normalize." But what is normal? Since equity and debt are contractual claims on the same asset, they should be (and have been) positively correlated over time. While those correlations are low and offer long-term diversification properties, they are not negative, as many continue to claim and expect.

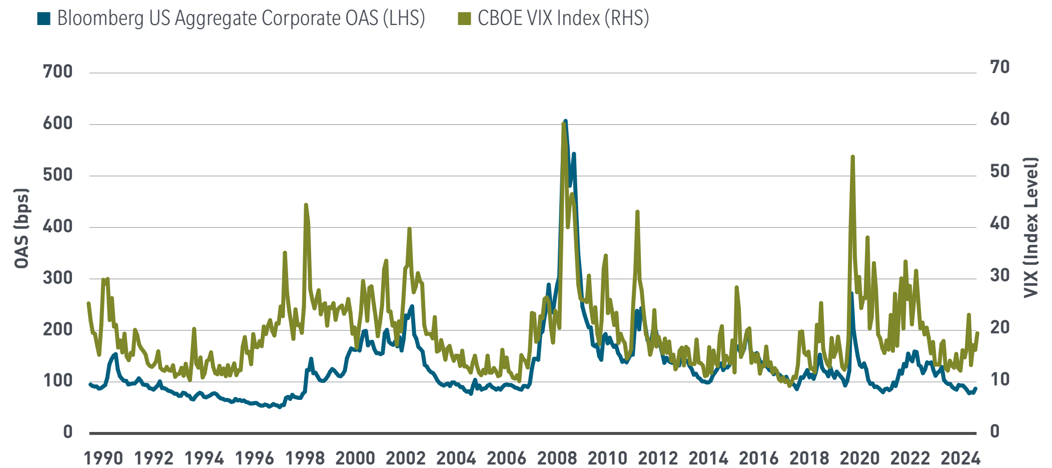
The quantitative easing cycle of the 2010s did more than produce abnormal return outcomes for stocks and corporate bonds, it distorted normal price patterns and produced negative correlation between these asset classes. For first-time asset allocators in this period, their experience may have led them to believe in a relationship that came about via an artificially generated 5,000-year low in interest rates.

More importantly though, this anchoring bias may have created a blind spot where corporate bond investors are not seeing the signal from equities.

Wider spreads often come with rising equity volatility

Given credits and stocks are claims on the same asset, we shouldn't be surprised to find a positive relationship between the VIX, the most-followed measure of US equity volatility, and US investment grade bond spreads (Exhibit 1).

Exhibit 1: Equity volatility is elevated, but credit spread moves are modest



Source: Bloomberg, Chicago Board Options Exchange (CBOE). Monthly data from 31 January 1990 to 28 February 2025.

While equity volatility has risen this year, credit spreads have remained well behaved. Which market is correct? I think there are two high-level considerations.

First, larger, more liquid asset classes are generally more efficient than smaller, less liquid ones, suggesting that the equity signal is more prescient than the credit markets one.

Second, throughout my time in financial markets, I’ve heard how bond investors are perennial pessimists while equity investors are optimists. While the risk versus reward potential of the two asset classes is clearly skewed, I don’t believe either label is true. While an oversimplification, credit analysts study cash flows and arrive at probabilities of coupon payments being missed while equity investors build probabilities around how much of the revenue will flow to the bottom line after operating expenses, depreciation, and the like. Stated another way, they each analyze the same company but through a different lens, so they prepare differently and unknowingly develop different blind spots.

While a generalization, downward pressure on equities has stemmed from investors forecasting how tariffs will negatively affect revenues, costs and profits, which in turn, are pushing recession odds higher. So of course, equity markets have moved first. And if stock investors are right, this will inevitably affect balance sheet leverage and default probabilities in adverse ways, driving credit spreads wider.

Conclusion

While we can’t predict the future, we can only offer perspective. Regardless of the outcome, investors should be prepared for whatever may come.

While stress-testing balance sheets and underwriting how a company’s cost structure may change materially in a high-tariff, lower growth environment is par for the course, I think chance will favor the most prepared investors who recognize blind spots and seek help from their equity or fixed income colleagues.

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