TRANSCRIPT

Looking Outside for Better Decisions

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Why do studies show that 90% of worldwide transportation projects underestimate the actual costs that are incurred?

It is not for lack of very detailed plans or resources. Research suggests that it may be due to holding a less than optimal viewpoint.

Most forecasts are made using the inside view – that is, they use inputs specific to the project under consideration such as careful evaluation of the team members, resources, and known issues.

However, no matter how well-considered these plans are, they often are wrong. That is because they cannot account for unknown variables such as team members having personal problems, such as illness, that impedes their work or external factors that hinder progress.

How could any forecast possibly incorporate these unknown variables?

By using the outside view. Problems and pitfalls that may have been unknowable do not have to be unpredictable. They are implicitly quantified and embedded within the outside view. That is because the outside view is based on “reference class forecasting,” or the incorporation of a wide array of data from comparable projects. This method has three steps:

1) Identify a comparable reference class – say, home construction

2)Aggregate the data from the reference class to determine a baseline estimate - perhaps cost or time to complete construction

3) Adjust the baseline estimate by the specific circumstances, which could be rockier land or more experienced builders

In this way, the experiences of many others influence the particular forecast in question. Therefore essentially unknowable issues are incorporated into the estimate, making for what is likely a more accurate prediction.

The inside vs. outside view can be applied to investing. We see the inside view all the time in the media. On TV pundits often discuss future equity returns in terms of economic indicators, earnings reports, and central bank actions. The outside view, by contrast, starts with the historical statistics and then makes adjustments. For example, when we look back at the past several decades, we find that over 80% of the variation in 10-year annual equity returns is determined by the beginning price-to-earnings multiple (P/E). Assuming this historical relationship continues, one could estimate a projection for 10-year annualized equity return with reasonable confidence. This estimated return could then be adjusted for current circumstances.

So the next time you have a difficult decision or forecast to make, first gather the comparable data. Looking outside of our own situations should help us make better decisions, something we care deeply about at Alger, where making optimal investment decisions is our highest priority.

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