PRICEVALUEPARTNERS

The only three words that count

"Bank of Mum and Dad bailed out by Bank of Nan and Grandad"

- Headline from The Daily Mash.

The Yale Endowment, under the management of its Chief Investment Officer David Swensen (author of two highly recommended books on investing – *Pioneering Portfolio Management* and *Unconventional Success*) since 1985, has a deserved reputation for generating superior investment returns. But for the fiscal year ending in June 2009, the Endowment lost a quarter of its value. What went wrong ?

The financial crisis of 2008 needs little introduction. But it hit the Yale Endowment particularly hard. Apparent diversification failed. Its holdings in various forms of listed equities fell in price by double digit percentages. Its 'absolute return' funds fell by over 9%. Private equity investments fell by over 24%. Its holdings in real assets fell by over one third. Its energy investments lost 47.4%.

Yale in 2008 was underweight just about the only asset that might have staunched the bleeding; as it concedes,

"The University's holdings of U.S. Treasury bonds, which provided a rare safe haven.. returned 5.1%. Yale's allocation of only 4% to bonds, motivated by fixed income's unattractiveness to long-term investors, provided little protection to the portfolio."

In Yale's defence, the Endowment is effectively a permanent portfolio with no obvious end-point in terms of an investment horizon. In other words, incurring even a dramatic drawdown during a given year is interesting, but barely significant in the context of its longer term mandate.

Nevertheless, most individuals and institutions – we suggest – would respond to a portfolio shedding a quarter of its value over 12 months with something akin to despair, leading, potentially, to an even more damaging investment policy by way of an overly emotional response.

If even Yale's finest investment minds were unable to construct a sufficiently robust safe haven for its portfolio to weather 2008's storms, what hope is there for the rest of us ?

This is partly a problem of framing effect. We may not even need to try to emulate the Yale team. Their staff presumably diversifies their mixed portfolio on the basis of forecasts for each asset class: hedge funds, private equity, emerging markets, and all the rest. The focus, one assumes, is on maximising returns given the Endowment's long term horizon. Short run volatility can look after itself.

Whether this kind of approach is suitable for an individual investor is an intriguing question. In any event, we endeavour to construct a balanced portfolio not on the basis of maximising returns in isolation, in deference to some presumed but unspecified 'long term' – which many individual investors will in any case abandon at the first sign of storm clouds on the horizon – but on the basis of maximising returns *whilst simultaneously minimising the potential for incurring permanent capital loss even in the short term*. (We define risk in terms of the likelihood of incurring a permanent capital loss, not simply encountering price volatility.) The addendum is required as a pragmatic acknowledgment that people tend to be loss averse, and that bad decisions are often made in the heat of the moment. Better, then, to avoid entering an overheated kitchen in the first place. To put it another way, we will allocate to our asset class universe (comprising objectively high quality bonds; value equities; uncorrelated assets; and real assets, notably the monetary metals) ensuring that we always have some skin in each game, and then trying to favour the least worst investments from each camp. Not necessarily the best, but ideally the least worst. In such a challenging investment environment as the one we all currently inhabit, capital preservation in real terms is surely a more sensible objective than maximising capital growth with all the attendant and inevitable risks.

Three words that matter ? ***We don't know***. We didn't know how markets would evolve back in 2008, but we feared the worst. We don't know how markets will evolve today, but we continue to prepare for a storm that may not come any time soon. Mindful of the terrible difficulty of forecasting anything tangible in such a threatening financial world, we continue to make those allocations – to high quality debt; to value equity; to uncorrelated funds; and to real assets. We can clearly have a view as to the relative merits and demerits of each, on the basis of bottom-up valuation and apparent prospects, but we still feel an obligation to commit to each – otherwise we risk being blindsided by the unforecastable, as Yale effectively was in 2008.

Another three words that count ? **It doesn't matter**. As the Trump administration starts unleashing shock and awe on a bunch of rocks, Google Trends reveals a meaningful uptick in the number of online searches for the phrase 'World War 3'. But as Warren Buffett has written about at some length,

"Forming macro opinions or listening to the macro or market predictions of others is a waste of time. Indeed, it is dangerous because it may blur your vision of the facts that are truly important. (When I hear TV commentators glibly opine on what the market will do next, I am reminded of Mickey Mantle's scathing comment: "You don't know how easy this game is until you get into that broadcasting booth.")

"My two purchases [of farmland and real estate respectively] were made in 1986 and 1993. What the economy, interest rates, or the stock market might do in the years immediately following -- 1987 and 1994 -- was of no importance to me in determining the success of those investments. I can't remember what the headlines or pundits were saying at the time. Whatever the chatter, corn would keep growing in Nebraska and students would flock to NYU.

"There is one major difference between my two small investments and an investment in stocks. Stocks provide you minute-to-minute valuations for your holdings, whereas I have yet to see a quotation for either my farm or the New York real estate.

"It should be an enormous advantage for investors in stocks to have those wildly fluctuating valuations placed on their holdings -- and for some investors, it is. After all, if a moody fellow with a farm bordering my property yelled out a price every day to me at which he would either buy my farm or sell me his -- and those prices varied widely over short periods of time depending on his mental state -- how in the world could I be other than benefited by his erratic behaviour? If his daily shout-out was ridiculously low, and I had some spare cash, I would buy his farm. If the number he yelled was absurdly high, I could either sell to him or just go on farming.

"Owners of stocks, however, too often let the capricious and irrational behaviour of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behaviour of stocks, etc., some investors believe it is important to listen to pundits -- and, worse yet, important to consider acting upon their comments.

"Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators delivering an implied message of "Don't just sit there -- do something." For these investors, liquidity is transformed from the unqualified benefit it should be to a curse..

"During the extraordinary financial panic that occurred late in 2008, I never gave a thought to selling my farm or New York real estate, even though a severe recession was clearly brewing. And if I had owned 100% of a solid business with good long-term prospects, it would have been foolish for me to even consider dumping it. So why would I have sold my stocks that were small participations in wonderful businesses? True, any one of them might eventually disappoint, but as a group they were certain to do well.."

So in light of the seemingly deteriorating geopolitical outlook we elect to do.. precisely nothing by way of response. We have, we think, the good grace to concede that we don't know. And we have the stoicism to concede that it doesn't matter.

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