PRICEVALUEPARTNERS

**A four-letter word** **13th July 2020**

"Risk is what's left over after you think you've thought of everything."

- Carl Richards.

**What is risk ?** James Ball in his piece 'Anatomy of a fiasco: how Britain's pandemic defences failed' for *The Spectator* offers, essentially, one currently relevant practical example:

> In October, a panel of 21 experts from across the world gathered for the first of what promised to be a series of reports assessing readiness for pandemics. 'Infectious diseases know no borders,' warned the Global Health Security Index. 'So all countries must prioritise and exercise the capabilities required to prevent, detect and rapidly respond to public health emergencies.' Every country was called to be transparent about its capabilities 'to assure neighbours it can stop an outbreak from becoming an international catastrophe'. Two countries were held up as the best examples: Britain and the United States.
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> If a league table were drawn up of countries that most failed to contain Covid deaths, the US and the UK would be pretty near the top. Yet both spent huge amounts of money on their pandemic preparedness and flattered themselves that their experts had built the strongest defence. The UK was ranked best in the world for its ability to stage 'rapid response to and mitigation of the spread of an epidemic'. It was given 92 points out of 100. Six weeks later, the first Covid-19 case was recorded in China and the real test began.

That is to say, one instance of risk is a wildly inflated and wholly unjustified sense of overconfidence. Overconfidence is not exactly unheard of in fund management circles either.

Older economists than Harry Markowitz, the godfather of modern portfolio theory, never even dared to define risk. Although there was keen discussion among economists, before World War One, as to what risk might be, and whether it was the same thing as uncertainty, there was complete agreement that whatever risk was, it was probably too complex a thing ever to be fully understood and, crucially, that it was incapable of mathematical calculation.

But Markowitz essentially put a figure on risk. Risk, post-Markowitz, equated to the annualised standard deviation of a portfolio's return – in other words, how much its net asset value wobbled. Not the likelihood of complete financial failure for the portfolio's owner, but merely the extent to which its net asset value oscillated around a mean.

Peter L. Bernstein, in his biography of risk, *Against the Gods*, suggests that the sea change in attitude towards risk came about because of widespread revulsion at the horrific slaughter of the Second World War. The awful toll on human life bred an attitude that international cooperation could and should be organised so as to prevent any recurrence of that tragedy, and to try and improve the human condition in general. This attitude gave rise to new international organisations like the United Nations, the World Health Organization and the World Bank.

Now we know, with the ugly benefit of hindsight, that the biggest risk facing the world in 2020 was not the rise of a new disease out of China, but the return of Big Government, whose attempts to deal deftly with the problem would make the average elephant seem balletic.

So now we are left with the grisly combination of an economy forced into virtual house arrest, arbitrary Big State intervention, and monetary authorities hosing the wreckage with liquidity. Good luck modelling, or macro forecasting, your way out of that.

One type of risk that investors who delegate the management of their capital to supposed professionals may now wish to consider with some urgency can be termed *career risk*, not least because it is the sort of risk that will never be visible in a portfolio report.

Successful investing requires some form of an edge. If you do not know what your edge is, you do not have one. In the case of firms like Berkshire Hathaway, for example, their proprietary edge is that their CEO is a master of asset allocation. In the case of most institutional funds, superior size is no edge at all. (Marketing heft is not an edge.)

You do not need to be a die-hard contrarian to have an edge – the financial markets, even today, offer up almost infinite opportunities for patient capital. Given the competition from vast numbers of rival investors, it invariably pays to go down the road less travelled. You can call this asymmetric warfare, if you like. Pension funds are obligated to own assets that match their liabilities. In most cases, that means they are forced to own bonds – irrespective of their price, or yield – if they even have one.

Large equity fund managers have similar weaknesses. Mutual fund managers will be obligated to manage their assets versus some kind of index or benchmark – likely the S&P 500 equity index for a US domestic fund, or the MSCI World Equity Index for an international mandate.

Today, approximately 65% of the MSCI World Equity Index consists of the US equity market. Many international equity fund managers, being benchmarked, have little or no choice but to own US stocks regardless of whether they want to or not. ***The typical fund manager is more concerned with career risk than maximising returns***. As Keynes put it, the institutional imperative practically forces him to fail conventionally rather than being seen to succeed unconventionally.

But as a private investor, you are under no such obligation. You can invest wherever you like. You can buy stocks, or funds, from any sector you wish, with any market capitalisation (small-cap stocks are inevitably less well covered by the research community, giving rise to significant opportunities, albeit with somewhat higher attendant volatility). You do not have to worry about your portfolio being beset by redemptions from other investors. You do not have to fret about your quarterly performance and your investment performance versus your peers.

Few investors at the end of 2019 would have foreseen the global spread of a virus, possibly of zoonotic origin, that would spread through nosocomial contact, making Covid-19 essentially an iatrogenic illness facilitated in large part by the National Health Service theoretically supposed to suppress it. Even fewer investors would have foreseen the response to date by financial markets. In his latest book *The Psychology of Money*, Morgan Housel cites the Stanford professor Scott Sagan, who

> once said something everyone who follows the economy or investment markets should hang on their wall: "Things that have never happened before happen all the time."

Given the propensity of real life to throw surprises at us, those investors seeking to preserve as well as grow their capital would be well advised to widen their opportunity set as far as humanly possible. Within our managed account portfolios, we do so in three ways. Within the realm of listed equity investments, we absolutely require a genuine margin of safety (perhaps best summarised as robust cash flow in conjunction with a compelling valuation). To diversify against equity risk and our own predictive overconfidence, we allocate to completely uncorrelated investments in the form of systematic trend-following funds with the potential to immunise capital against unforeseen and perhaps even unforeseeable shocks. And to further diversify against monetary, fiat currency and fiscal absurdity, we invest in real assets, notably the monetary metals, gold and silver, and related concerns trading at undemanding multiples. Hoping for the best and preparing for the worst need not be incompatible.

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