

PRICEVALUEPARTNERS

On risk and reward

“On Sunday, the eyes of the world will be on the Oscars. But two people already know who's won.

You've never heard of Martha Ruiz and Brian Cullinan. They haven't been in any films or on any magazine covers. But they will be the most important people at the Oscars.

They are the only two people in the world who know the names of the winners before each award presenter rips open the golden envelope and says the immortal words: "And the Oscar goes to..."

Ruiz and Cullinan have counted the votes - and counted them again, and again, to make sure the results are correct.”

- ‘The woman who knows who’s won the Oscars, but won’t tell’, Ian Youngs, [BBC News](#).

It would be difficult to imagine modern life without a conception of risk. In the words of Peter Bernstein, whose *Against the Gods* amounts to a biography of risk,

“The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk: the notion that the future is more than a whim of the gods and that men and women are not passive before nature. Until human beings discovered a way across that boundary, the future was a mirror of the past or the murky domain of oracles and soothsayers who held a monopoly over knowledge of anticipated events.”

Thinkers and mathematicians gave us probability theory and in doing so fashioned the apparent chaos of chance into at least a semblance of order by way of risk management.

“By defining a rational process of risk-taking, these innovators provided the missing ingredient that has propelled science and enterprise into the world of speed, power, instant communication, and sophisticated finance that marks our own age. Their discoveries about the nature of risk, and the art and science of choice, lie at the core of our modern market economy that nations around the world are hastening to join. Given all its problems and pitfalls, the free economy, with choice at its centre, has brought humanity unparalleled access to the good things of life.”

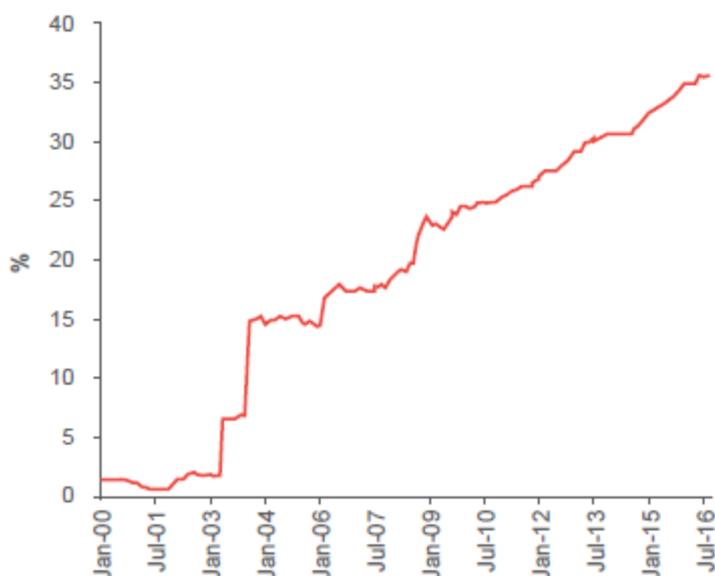
But as Immanuel Kant observed, out of the crooked timber of humanity, no straight thing was ever made. The ‘wild card’ in the game of risk is our own psychology. The Swiss mathematician Daniel Bernoulli features prominently in Bernstein’s biography of risk, and has some claim to being one of the very first behavioural economists. As he suggested, when managing the assets of wealthy people,

“The practical utility of any gain in portfolio value inversely relates to the size of the portfolio.”

In other words, the primary focus of asset management for the wealthy should be on capital preservation – on absolute return, rather than market-relative, investing. It is now a matter of keen debate whether loss aversion on the part of the wealthy is actually a universal preference. Michael Lewis’ *The Undoing Project*, effectively a biography of the psychologists Daniel Kahneman and Amos Tversky, suggests the condition is omnipresent – that we are **all** loss-averse, irrespective of the degree of our wealth.

In which case, much of the asset management industry is poorly configured and possibly unfit for purpose. Amongst institutional fund managers, for example, the investment focus is typically not on the generation of absolute returns, but on market-relative ones. Aided by a regulatory mindset which encourages low fees at the expense of discrimination, passive investment funds are eating everybody else’s lunch. The following chart comes courtesy of Ian Lance of RWC Partners.

GLOBAL PASSIVE EQUITY FUND SHARE OF TOTAL EQUITY FUND NET ASSETS



Source: EPFR Global and Bernstein analysis, 01 January 2000 - 31 July 2016

Low cost, index-investing pioneer Vanguard Group has just surpassed \$4 trillion in assets. If this rate of asset growth continues, at some point in the near future they will **be** the entire market.

The subtlety of asset management that has meaning lies in the disparity between want and need. Investors may believe that they want low cost market exposure. What they probably need is in fact the probability of attractive long term returns with minimal risk. By risk we mean not the standard industry definition (volatility of investment returns) but rather the likelihood of permanent capital loss. Buying “low cost” market-relative tracker funds at arguably unsustainable valuations close to the peak of the market seems like a guaranteed way of encountering such a risk.

The US stock market now accounts for 60% of the MSCI World Index. That should give global passive investors some food for thought, given that the Shiller cyclically adjusted p/e (CAPE) ratio for the S&P 500 index stands at 80% above its long run average.

Japan accounts for 9% of the MSCI World Index but we doubt whether the average private client has even a third as much exposure to that market within their own portfolio. A 25-year bear market has left a substantial amount of scepticism in its wake. Nevertheless, over 40% of Japanese stocks trade **below** book value, and domestic institutions including the BoJ, the GPIF and Japanese companies themselves are committed to supporting the market and either buying, or buying back, stock. Meanwhile, dividends are being raised across the board, and innumerable companies, especially in the small and mid-cap space, are quietly reporting record profits. (The retrenchment of Wall Street research in these areas may account for the lack of news coverage of this extraordinary investment environment.) Having just spent a week in Tokyo and Osaka visiting such companies, the sense of opportunity in the air is almost palpable. Conventional wisdom would have it that investing in Japan is a risk. We would suggest that the real risk in Japan is not owning enough of it.

tim.price@pricevaluepartners.com

Tim Price is co-manager of the [VT Price Value Portfolio](#) and author of ‘Investing through the Looking Glass: a rational guide to irrational financial markets’. You can access a full archive of these weekly investment commentaries [here](#).