Professional Investors Manage Risk

"No winter lasts forever; no spring skips its turn"
– Hal Borland

The U.S. stock market has ripped higher from the March 23, 2020 lows. A naïve strategy of loading the boat up with market darlings has produced awe inspiring gains from the date of the trough onward. It seems daily, I read or hear about novice investors beating the professionals at their own game. This doesn't feel right to me – in fact, I know it isn't.

A rising tide lifts all boats, and that is exactly what is going on today. Novice investors are buying the highflyers with only one thing in mind, that is, how much money can be made. The newbies are ignoring the flip side of that coin which is, how much money can be lost.

Managing risk is the number one priority of the professional investment manager. Professional investors need to understand this concept because market drawdowns happen regularly. Professional investors are aware over the long-term, it is not how much money you have made in any given year, but rather how much money you didn't lose.

I wrote the below newsletter in December 2017, a year in which US stocks realized high returns yet historically low volatility and drawdowns. Today's economic, political and market environment are quite different in comparison, however the human emotional aspect is the same as it ever was.
*****

Go for It! Swing for the fences! No guts, no glory! These popular phrases are often blurted out when something risky is on the line. Whether you are a professional athlete looking for a win, an entrepreneur starting-up a business, or a newly engaged couple committing to a relationship, much of what we encounter throughout our lives deals with taking either direct or indirect risks.

As an investor, risk taking is unavoidable. The question many of us must come to terms with is - how much risk am I truly comfortable with? Do I swing for the fences and go for broke, or do I stash my money away in a savings account and rest easy at night? When times are good, investors tend to overestimate their willingness to take-on risk, and when times are rough the opposite is often the case. To invest successfully, knowing oneself can be far more important than financial acumen.

Many experienced investors are aware of the importance of avoiding large losses and the negative effect this has on compounding returns. As a simple example, using a theoretical investment of $1,000,0000, we can observe how much must be gained after a loss, in order to make it back to breakeven. A -10% loss turns the original investment into $900,00 and requires a +11.1% return to get back to $1,000,000. A -30% loss turns the original investment into $700,000 and requires a +42.9% return to get back to $1,000,000. While a -50% loss turns the original investment into $500,000 and requires a +100% return to get back to $1,000,000. Simply put, the larger the loss, the more difficult it is to work your way back to even.

The illustration above may be intuitive for many readers, however equally if not more important is a related concept, which focuses on the impact of portfolio volatility and its effect on long-term investment performance. Too often, investors, and sadly some investment managers are solely focused on producing big returns at the expense of tolerating high levels of volatility. This is a mistake.

Variance drain, also known as volatility drag, are the terms used to describe how different levels of portfolio volatility result in markedly different returns over time. Variance drain operates under the theory that comparing two portfolios with the same beginning and same average returns, the portfolio with the greater volatility will have a lower compound return, and therefore less ending wealth. Not only does controlling portfolio volatility make investors feel more comfortable, which enables them to stay the course, but minimizing volatility actually grows wealth faster than more volatile portfolios which exhibit the same or even higher returns.

Marc Odo, of Swan Global Investments, did a good job describing this concept in a blog post, "Volatility is a Drag" dated September 29, 2016. He starts with the illustration below asking which of the following three scenarios would yield the best 10 year results:

1. A portfolio up 10% one year, then down 5% the next year, with this pattern repeated for 10 years.

2. A portfolio up 25% one year, then down 20% the next year, with this pattern repeated for 10 years.

3. A portfolio up 40% one year, then down 35% the next year, with this pattern repeated for 10 years.

And the winner is… Portfolio number 1. Despite its modest gains and losses, Portfolio 1 performs the best and is the only profitable scenario. Portfolio number 2 breaks even, while Portfolio 3 loses money.

Variance drain was first introduced in The Journal of Portfolio Management by Thomas E Messmore in the 1995 summer edition. Messmore concluded that the more volatile an assets return, the greater the difference between its arithmetic and geometric returns. For readers who would like a better understanding of the math behind the above outcomes, please see the links provided here for definitions of arithmetic versus geometric returns.

To get a sense of how important controlling volatility in an investment portfolio can be, I reproduced the below eye-opening table on variance drain, which was originally published in the book "The Stewardship of Wealth: Successful Private Wealth Management for Investors and Their Advisors" by Gregory Curtis. Readers will find six scenarios, with different levels of volatility as measured by standard deviation, all corresponding to a 10-year time horizon. Notice as a portfolios Standard Deviation increases the Ending Funds and Total 10 Year Period Return % decreases.

10-Year Returns Based on Different Portfolio Volatilities

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
Arithmetic Annual Return	**10%**	**10%**	**10%**	**10%**	**10%**	**10%**
Standard Deviation	0%	10%	20%	30%	40%	50%
Geometric Annual Return	**10%**	**9.6%**	**8.3%**	**6.03%**	**2.58%**	**-2.42%**
Starting Funds	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Ending Funds	$2,593,742	$2,501,561	$2,219,353	$1,796,293	$1,290,725	$782,784
Total 10 Year Period Return	**159%**	**150%**	**122%**	**80%**	**29%**	**-22%**

Source: Greycourt

We live in unusual times. Both political and economic anxiety appear high, yet market volatility has been running at historic lows. I believe many market analysts are correct in implicating central bankers (Fed, ECB, BOJ, etc.) as being the main culprit behind asset price inflation and volatility suppression. At some point, asset purchases by global central banks will cease completely and liquidity will be drained from the market. Buying the highflyers with little regard to managing market risk could prove to be punishing. Investors who focus on thoughtful portfolio construction should prevail over the long-term. In the meantime, let's enjoy this Goldilocks market while it last, as nothing is forever.
*****

The market melt-up is in full effect and I don't expect the winds to shift meaningfully anytime soon. The presidential contest is behind us and Joe Biden is our President. The financial markets like the certainty of this transition and have responded positively.

Additionally, multiple COVID-19 vaccines are set to be distributed to the population on a massive scale soon. Economic growth has been picking back up and the major US equity indexes are either at, or approaching new highs. Interest rates are at historic lows and will likely stay very low for a long period of time. This is all supportive for good investment returns right now and into the future.

The key will be staying the course, which is where superior portfolio management and advice come into play. A 100% equity portfolio is too volatile for most people and will likely push investors off their game too soon, while 100% of one's assets allocated to cash, money markets and bonds will slowly lose out to the corrosion of inflation and is also inappropriate. Balancing risk versus reward is how this is done at the professional level.

ASSET CLASS & SECTOR OPINIONS		
OVERWEIGHT	**NEUTRAL**	**UNDERWEIGHT**
U.S. Real Estate & Related Equities	Materials Sector	International Developed Market Equities
Large Capitalization Technology	Communication Services Sector	Financial Services Sector
Consumer Discretionary Sector	Healthcare Biotech & Pharmaceuticals	Leverage Loans (Floating Rate Debt)
Healthcare Equipment	Consumer Staples	Treasury Inflation Protection Securities
Energy Related Equities	Mortgage Backed Securities	Gold & Gold Miners
Small Capitalization Stocks	Local Currency EMG Bonds	
Aerospace & Defense	High Yield Corporate Bonds	
Emerging Markets Equities	Investment Grade Corporate Bonds	
	U.S. Treasury Notes & Bonds	

Sincerely,
Justin Kobe, CFA
Founder, Portfolio Manager & Adviser
Pacificus Capital Management