the advisor

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Negative Art

"Rule Number One: Never lose money. Rule Number Two: Never forget Rule Number One."

Warren Buffett

Ninety-three year old Buffett, who knows a thing or two about successful investing, is not suggesting you cannot ever lose money - but he is emphasizing the mindset investors should possess.

It is gratifying to find winning investments. And winning periods are always welcome. But for all of the winners there are also an awful lot of losing investments. Over time, avoiding the losers (and losing years) could help you in achieving your financial objectives. Let's follow some threads ...

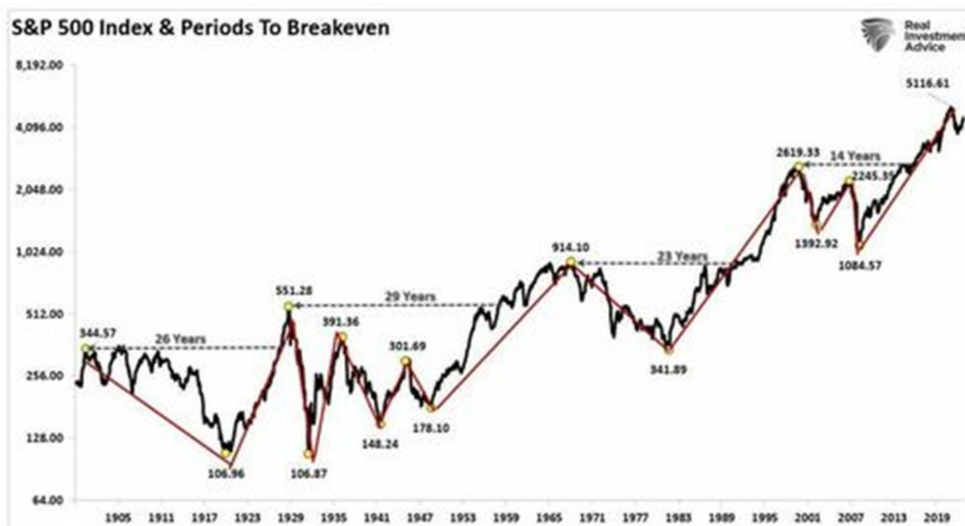
According to legendary investor Howard Marks, "... investors improve their performance not through what they buy, but through what they exclude – not by finding winners, but by avoiding losers. ... [It] is a negative art."[1]

Marks feels strongly "… that attempting to achieve a superior long-term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year – and through discipline to have highly superior relative results in bad times - is:

- less likely to produce extreme volatility,
- less likely to produce huge losses which can't be recouped and,
- most importantly, more likely to work (given the fact that all of us are only human).

"Simply put, … the best foundation for above-average long-term performance is an absence of disasters."[2]

And what a catalogue of investment disasters there have been over the past century. From the 1930's Depression, 1970's Nifty-Fifty, on through the 2000's dot.com bubble and sub-prime disaster and then onto a 2020 global pandemic. Thousands of companies have been obliterated, as one would expect in a capitalist system. Stress in the financial markets typically helps remove weak and sickly companies from the economy. However, periods of stress can also prolong the time it takes investors to recover from losing years. (See chart this page)



In fact, a number of factors affect your investment success. Investors must consider the impact of taxation and carefully weigh future inflation expectations. The geopolitical situation should also be evaluated. Rules should be implemented for spending, for saving and for allocating investments. Then investors ought to stick to their rules and avoid the temptation to chase speculative securities. The more risk an investor takes within a portfolio, the greater the destruction of capital will be when mean reversions occur.

The markets will always experience challenging periods. Withdrawals from portfolios during declining market environments will accelerate depletion of capital. Therefore, plans should be made during the winning years to set aside funds for reduced portfolio withdrawals during those challenging market conditions.

Your life expectancy also plays a significant role in future outcomes. While it is possible to recover from losses after a market downturn, what can never be regained is the time forgone. Time is finite and the most

Negative Art (cont'd)

precious commodity investors have.

Understanding potential returns from any given valuation point is essential when considering investing. Risk is an important concept as it is a function of loss. Investors should consider the implications on their investment time horizon.[3]

Hedge fund mangers, Victor Haghani and James White, authors of "The Missing Billionaires", suggest a framework to minimise investment mistakes. Determining losers ahead of time is challenging. Instead, the authors examine a much more important question than picking the right investments: *how much to buy or sell*.

The main concept of the book regards "expected utility", an economic hypothesis concerning human preferences when making decisions under uncertainty. Most investors are averse to risking large amounts of their capital. Sizing investments to maximise expected utility, rather than to maximise wealth, can sharply reduce the chances of intolerable losses while keeping enough risk to aim for decent returns.

In practical terms, " … the book's crowning achievement is its explanation of the "Merton share". This is a simple rule of thumb for determining asset allocation, which says that allocations should rise in proportion to expected returns, fall in proportion to the investor's risk aversion and fall a lot in proportion to volatility."[4]

Over the past twenty years, two massive bear markets have left many individuals further away from retirement than they ever imagined. With yield curve inversions and with rising interest rates on an obscenely leveraged economy, the risk of another market downturn is not insignificant.

Moreover, we are approaching the limits of debt efficacy. In the early stages of all debt super-cycles, GDP growth and debt grows roughly 1:1. However, as the cycle matures, it takes more debt to grow GDP. Debt then becomes a drag on economic growth. When the ratio reaches about 4:1, (i.e. it takes $4 of additional debt to grow GDP by $1), the party is effectively over. In the past 300 years, every single time the ratio has reached 4:1, "the debt super-cycle has collapsed – every single time …" and that time is looming.[5]

It would be imprudent to expect interest rates to fall much because the government continues to borrow indiscriminately. Unfortunately, reckless fiscal policy seems likely to continue. So in order to get lower rates, policymakers will instead be forced to destroy economic demand. Until recently, most investors would have not believed that interest rates could stay as high for as long as they have. The bond market now expects, and central bankers insist, that interest rate levels will remain restrictive.

Normalising interest rates was never going to be easy. If yields stay at or around 5% for a prolonged period, the strain across all credit markets will only intensify. Property borrowers will struggle to refinance as term loans come due. Commercial and residential property values will remain under pressure. Leveraged companies will pay much higher borrowing costs, increasing the ranks of zombie companies. Defaults will grow and the US consumer will retreat. And this assumes nothing "breaks" in the economy.

Unfortunately, it is probably the "breaking" - and not merely a slowdown in the rate of inflation - that will prompt central banks to reduce interest rates. Negative events could be anything from a budget crisis to a currency crisis to a default crisis. Eventually interest rates will move lower, but that will probably only be the result of economic distress, not of successful policymaking.

Uncertainty typically creates volatility, lower prices, and even a bigger profit potential than would otherwise be offered. The trick is portfolio resilience so you are able take advantage of what is on offer. Patience is crucial.

Someone once asked Amazon founder Jeff Bezos the best advice he ever received from Warren Buffett. Bezos asked Buffett if his investment ideas are so simple and he's so rich why doesn't everyone copy him? Buffett replied, "Because nobody wants to get rich slow."

The next few years might see winners simply keep winning, because they're grounded in history. More likely, investors will grasp for wealth, yet will mostly end up holding dust. Last generation's winners could surrender everything.

Today's leading economic indicators are sharply negative. Valuations are elevated, sentiment is deteriorating and the economy is going wobbly. A US recession is likely.

It's a well-recognised human bias to feel losses more acutely than gains. That is what economists mean when they claim there is more disutility in losses than there is utility in gains. That disutility could be minimised by more thoughtful investing and by careful sizing.

Perhaps it is not only what is in your portfolio that matters but what is absent. Be conscious of the risks that are in your control. Your future prosperity could depend on it.

Sources:

1. Howard Marks, Insights "Fewer Losers, or More Winners?", Oaktree Capital, 12 Sept. 2023
2. Ibid.
3. Lance Roberts, "Compound Market Returns are a Myth?", Real Investment Advice, 26 Sept. 2023
4. Buttonwood, "How to avoid a common investment mistake", The Economist, 21 Sept. 2023
5. Neils C. Jensen, Absolute Return Letter, 1 Sept. 2023
6. Chart page one, Lance Roberts, "Compound Market Returns are a Myth?", Real Investment Advice, 26 Sept. 2023

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