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Falling Chandeliers & The Evolution of Risk Management *(Part I)*

By Jamie Catherwood *September 2021*

One of Warren Buffett's famous investing rules is to win by not losing. In a 1985 *PBS* appearance the Oracle of Omaha said:

> *"The first rule on an investment is don't lose. The second rule on an investment is don't forget the first rule. That's all the rules there are."*

As usual, Buffett's instructions are *simple*, but not *easy*. Generally, however, there are two paths for following Buffett's rules. The first is to only make good investments that never lose money. Alternatively – and more realistically – manage risk through rules and processes that *increase* your probability of *positive* outcomes and *reduce* the odds of meaningful *losses*.

Few – if any – investors have a 100% hit rate in picking stocks, making the first approach impractical. COVID-19 also showed investors that certain risks just cannot be anticipated and can rock even the steadiest of portfolios. A 19th century edition of the *Spectator* offers a perfect analogy:

> *"The profoundest chess-player may see an inevitable mate, and yet, if the chandelier falls upon the pieces, may never win that game."*

As a chess player, how should you prepare for this risk?

1. Ignore this risk and solely focus on executing chess strategies that will defeat your opponent. Accept the odds that falling chandeliers prematurely ending your match are very low.
2. Thoroughly research and study how chandeliers are correctly installed, and meticulously inspect the installation quality of every chandelier that hangs above your chess table.
3. ***Don't play chess under chandeliers.***

This final option embodies the *second* approach to Buffett's instructions outlined earlier: manage risk by implementing rules and processes that *increase* the probability of *positive* outcomes by *decreasing* the chances of *negative* outcomes. In short, **don't play chess under chandeliers.**

For investors, these rules and processes for managing risk may take many forms. In terms of **investment strategy**, for example, negative screens can be utilized to *avoid* stocks with traits that historically underperform (lose). This might mean avoiding stocks of companies that are loaded up with debt and have declining earnings growth. While this does not guarantee that all companies "surviving" this filter are great investments, it creates a higher-quality universe of stocks to invest in. In short, probabilities of a *positive* investment are improved by *avoiding* stocks with "losing" characteristics.

At the **structural** level, investors can utilize vehicles that offer better risk management by enabling granular customization and control. For example, implementing rules and processes for risk management is much easier in a Separately Managed Account (SMA) owning individual securities than a "pre-packaged" mutual fund or ETF.

Finally, investors should leverage innovations in **technology and data analysis** to execute their risk management processes. In the current 'Age of Information', this has never been more important. For instance, it is only through advances in data analysis and technology that the screening factors for avoiding low-quality stocks can be implemented. As we will cover later, there have been *major* innovations on this front that investors should be aware of.

In truth, most financial innovations originated from a desire to avoid losses. **History demonstrates that advancements in risk management often stem from these key areas: investment *vehicles*, investment *strategy*, and innovations in *technology and data analysis.***

This three-part series will highlight that we are experiencing a boom in each of these areas, and investors should understand the tools available for managing risk. In doing so, investors can better follow Buffett's instructions to "win" by "not losing".

INVESTMENT VEHICLES: UNLOCKING NEW RISK MANAGEMENT CAPABILITIES

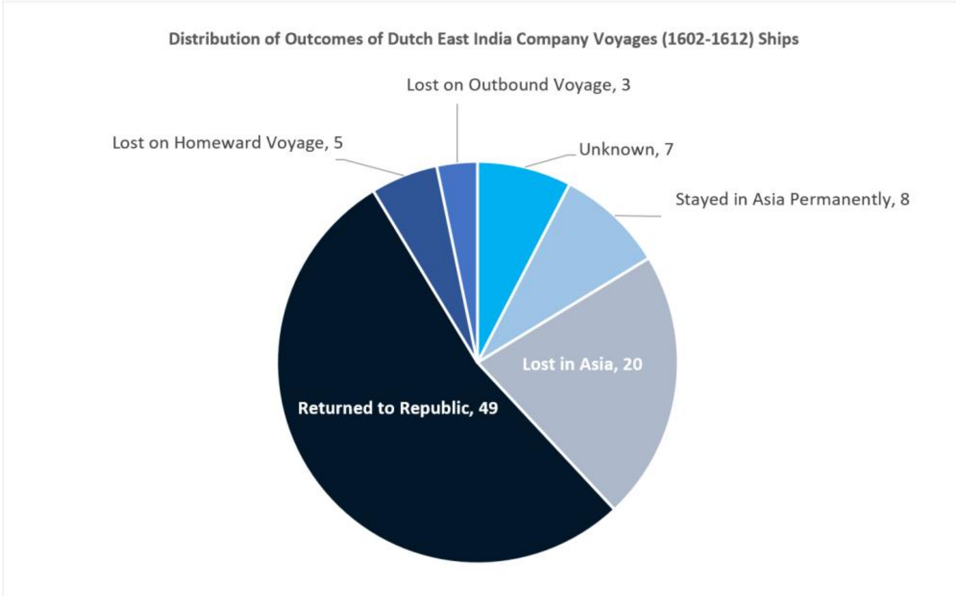
In this inaugural post, we will look at the role of investment *vehicle* innovations for unlocking new risk management capabilities. From diversification through commingled funds to corporate structures limiting liability, investment *vehicles* provide the underlying structure for investors to execute their risk management processes.

A History Lesson

For merchants in 17th century Europe, financing voyages was extremely expensive and only funded by the small group directly involved in each venture. Consequently, a merchant's capital was often concentrated in a single voyage. Not exactly "diversified".

Since merchant voyages often failed, this concentrated exposure was especially risky. The chart below shows that only 49 (53%) of 92 Dutch East India Company voyages between 1602-1612 returned safely.[1]

[1] Arthur Korteweg & Berk Sensoy, *How Unique is VC's American History?* (June 2021)



The solution to this problem was a new investment vehicle / corporate structure that facilitated better risk management capabilities: **the joint-stock company**. This innovation allowed merchants to form companies that could raise capital by selling shares to *outside* investors. By widening the investor base, the investment required from each individual was lowered. This reduced their risk and allowed merchants to diversify their remaining capital across *multiple* voyages.

> *"Distant voyages funded by multiple investors reduced this risk. Since each contributes a small portion, the risk borne to them is less than it would be if it were funded by one person.*
>
> ***The consolidation of assets in this manner makes each contributing member an owner, or shareholder, of a joint stock venture. The emergence of joint stock trading companies was created out of the need for increased funding requirements."***[2]

The joint-stock company example demonstrates how investment *vehicles* can provide the structure for unlocking new risk management capabilities.

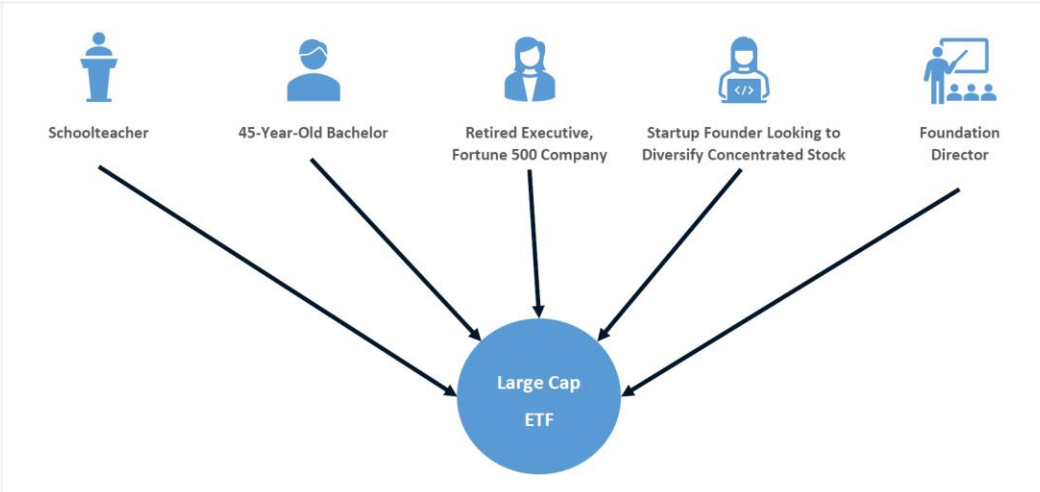
The Great Unbundling: Investment Vehicle Innovations Today

Today there is no shortage of options for diversified market exposure (ETFs, mutual funds, etc). Investors now face a different problem, which is ironically linked to the innovations offering this diversified market exposure: **lack of customization and control**.

Commingled funds are ***great*** because their "one-size fits all" structure allows them to offer one diversified strategy for thousands of investors at a low cost. However, these commingled funds are ***restrictive*** because their "one-size fits all" structure allows them to offer ***one*** diversified strategy for ***thousands*** of investors.

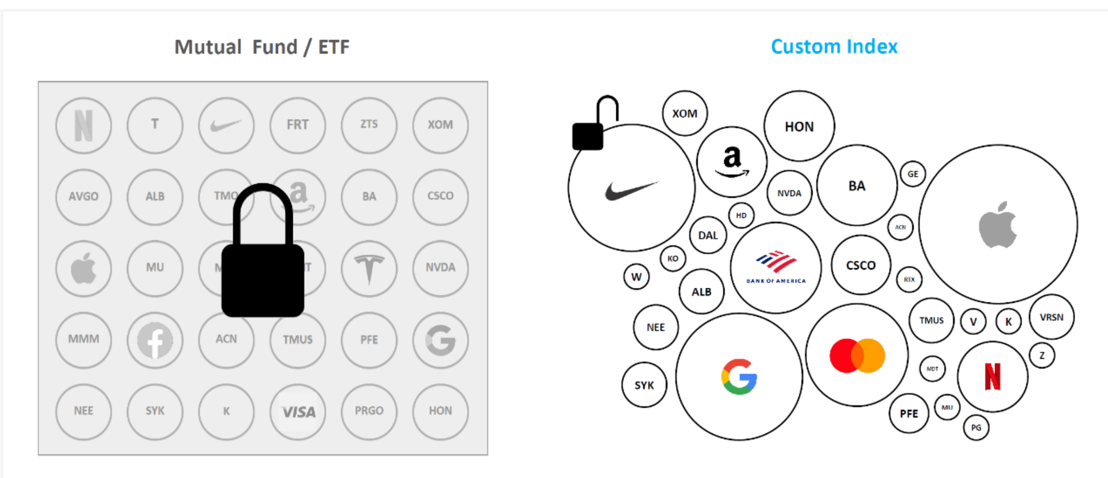
[2] Tu Kha Tran, *Growth of Joint Stock Companies in The 17th Century"* (2008)

ETFs facilitate risk management through diversification but cannot be customized to better address an individual's unique circumstances. This problem is illustrated below, where five investors with distinct risk profiles, incomes, and time horizons are grouped into *one* fund that treats every investor the same.



Like in the 17th century, it is an investment *vehicle* providing the underlying structure for a new innovation to build upon: **Separately Managed Accounts (SMA)**. These vehicles are unique because **investors *directly* own the underlying securities, instead of *indirectly* through shares of a pre-packaged mutual fund / ETF.**

The SMA vehicle, paired with recent innovations in portfolio management technology and zero-commission trading, have produced a new investment offering that customizes portfolios to each investor's unique risks and circumstances. Investors can think of this process as "unbundling" an ETF or mutual fund's holdings so that they can be customized to the individual: **Custom Indexing**.



By directly owning individual securities, Custom Indexing allows individuals to better manage their risk. For example, if a Texas family's wealth is directly tied to the Oil & Gas industry, they could manage that risk in a Custom Index by screening out all Energy stocks to avoid increasing their exposure further.

Implementing simple rules like underweighting / avoiding Energy stocks helps *reduce* the odds of meaningful losses by not *increasing* the weight of an already concentrated exposure in Energy. *"Don't play chess under chandeliers"*.

CONCLUSION

Investment vehicles provide the structure for implementing rules and processes to "win" by "not losing".

Commingled funds were revolutionary for providing access to diversified portfolios at a low cost. Due to advances in technology and investment vehicles, however, you don't have to choose between cost, diversification, *or* customization. You can have it all for the same cost, with diversification that works for you, and customized to any objectives you have.

In the next installment of this three-part series we will cover how technological innovations and advances in data analytics leverage this unbundled structure to manage risk more effectively than ever.

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