# Balancing risk and return

## Quarterly Letter

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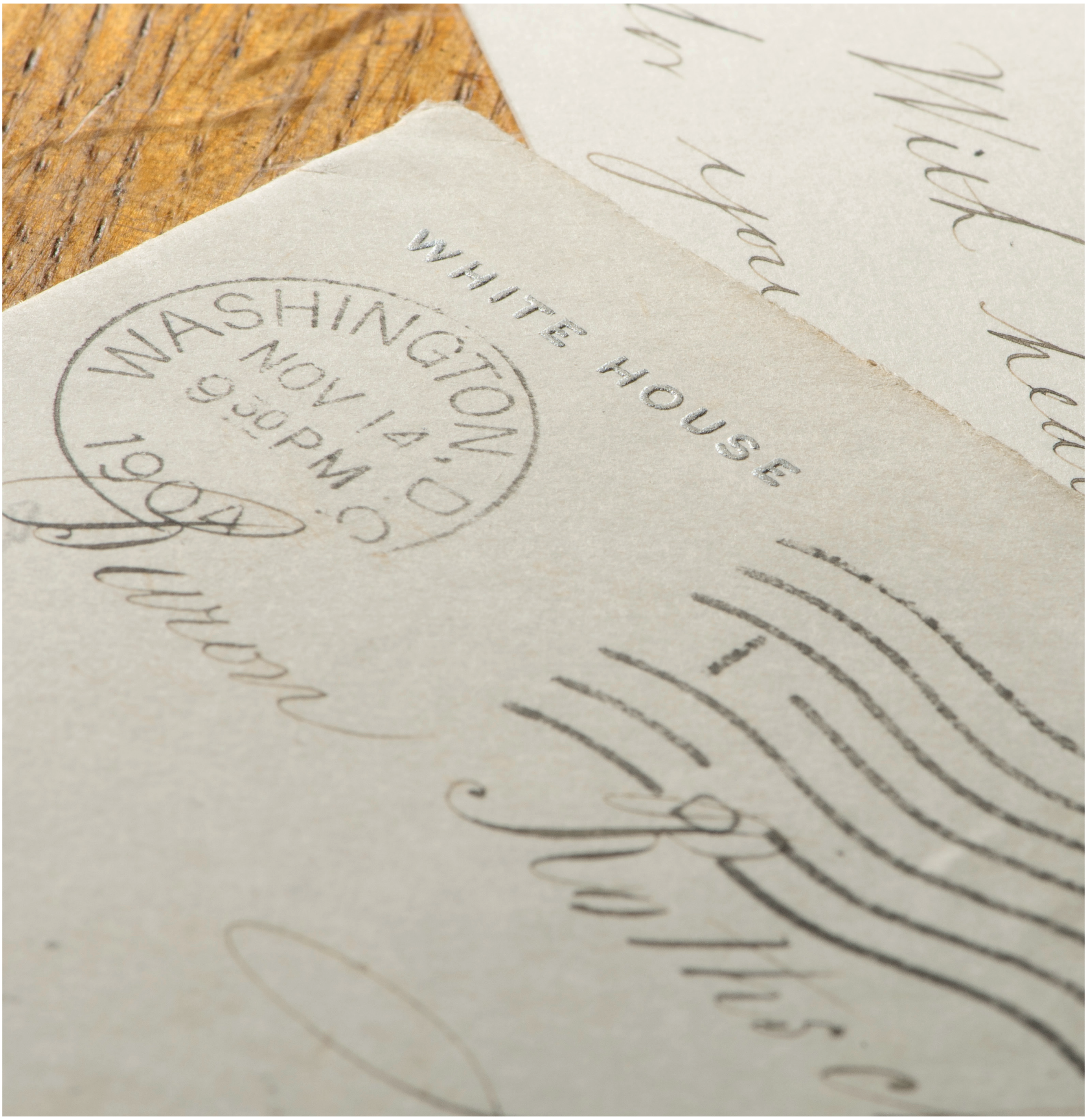



Rothschild & Co
Wealth Management

# Foreword

I hope you and your families remain safe and well.

Famed investor John Templeton once said the dot-com bubble was unlike anything he had ever seen before. Forbes, which was interviewing him in 2001, called it a ‘once-in-a-lifetime’ event.

Seven years later, then Deputy Governor of the Bank of England, Charlie Bean, said the 2008 GFC was a “once-in-a-lifetime crisis”. And in 2020, United Nations Secretary General António Guterres urged countries to work together to fight COVID-19, which he described as a “once-in-a-lifetime” pandemic.

These are just three examples across a 20-year period, and there are arguably many more. ‘Once-in-a-lifetime’ events occur far more frequently than you might think.

All of the comments above were made in the midst of major market uncertainty, so we can forgive a touch of hyperbole. Even so, they highlight an important point about investing: risk is everywhere, and even experts don’t know how serious a particular risk will be or how long it will last until it’s over.

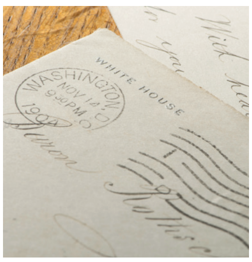
At Rothschild & Co, our approach to risk doesn’t rely on forecasting the future. We don’t try to predict exactly when economies will grow or shrink, what interest rates and inflation will be next year, or which direction the next big market shock is coming from. These can only ever be educated guesses.

We believe our time is better spent building portfolios that offer both attractive returns over the long term and the resilience to withstand loss-causing events.

In this *Quarterly Letter*, we’d like to talk more about how we achieve and maintain this delicate balance in order to preserve and grow our clients’ wealth, not just throughout their lifetime, but also throughout the lifetime of future generations.

With what looks like a reduction in risks to our health, I hope we can begin to see you in person in the coming months.

**Helen Watson**
CEO, Rothschild & Co Wealth Management UK




Cover image:
Envelope from a Presidential ‘Thank you’ sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904. Courtesy of The Rothschild Archive.

Rothschild & Co Wealth Management
New Court
St. Swithin’s Lane
London
EC4N 8AL
+44 20 7280 5000
rothschildandco.com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**"The avoidance of loss is the surest way to ensure a profitable outcome."**
**Seth Klarman, *Margin of Safety***

One day, a young hen is picking up corn in a field when – whack! – she feels a thump on the head. Looking down at the ground, she sees that an acorn has struck her.

"The sky is falling!", she promptly exclaims.

Many of you will be familiar with the story of Chicken Little. After being hit by the acorn, the plucky chick embarks on an adventure to tell the king that the world is ending, convincing a rag-tag bunch of avian friends to join her along the way.

Eventually, Chicken Little and the gang come across a fox. The fox tells them they are going the wrong way to the king's castle and promises to guide them in the right direction.

**David Ropeik claims the Perception Gap is responsible for many of the miscalculations people make when faced with potentially risky situations.**

Do you know how the story ends? Like many fairy tales, Chicken Little has become more family friendly over the years. But in the original, more gruesome, version the fox leads the hen and her friends into his den and eats them all one by one.

The story of Chicken Little can tell us a lot about risk: how it is perceived, how it is managed, and the dangers that lie ahead if we allow misconceptions to lead us astray.

Chicken Little encountered a risk (the acorn), interpreted it incorrectly (the sky is falling) and made a series of fateful decisions that worked out poorly for her and her friends (consumption by fox).

When investing, it can sometimes feel like the sky is falling, especially if markets are volatile and forecasters continue to make gloomy predictions for the future. The trick is keeping a steady head and being able to tell the difference between falling acorns and hungry foxes.

### The Perception Gap

Where did it all go wrong for Chicken Little? Let's start with the acorn. Getting hit on the head by an acorn is slightly painful, perhaps, but most of us would agree that it's nothing more than a minor inconvenience in the grand scheme of things.

That's because we know what acorns are and why they fall from trees. We have access to information that allows us to calculate the relevant risks and take proportionate measures to manage them.

Conclusion: avoid oak trees in autumn or wear a hat.

Chicken Little was presumably unaware of the flowering and fruiting behaviours of trees. We can hardly blame her; she's only a chicken after all. Her brain had to fill in a lot of blanks. As a result, her fears far outweighed the true risk of the situation.

International risk expert David Ropeik calls this phenomenon the 'Perception Gap'. It's the inconsistency between how we perceive a threat and the actual danger it poses. In his book *How Risky Is It, Really?*, he claims the Perception Gap is responsible for many of the miscalculations people make when faced with potentially risky situations.

For example, it explains why people are more afraid of travelling by plane than car, even though flying is statistically safer than driving. It's also why some people worry about radiation from nuclear power plants, mobile phones and microwaves, but fail to put on sun cream to protect themselves against solar UV rays in summer.

Many of these cognitive quirks are down to our reliance on mental shortcuts, known as heuristics, to quickly assess threats. Heuristics save time, which is crucial in dicey situations, but they essentially perform risk assessment by rule of thumb.

This problem-solving approach leads to many of the psychological biases that we've discussed in previous *Quarterly Letters*, including anchoring, confirmation bias and the endowment effect.

We'll explain some of the other factors that influence the Perception Gap a little later. First, we'd like to talk about how Rothschild & Co views risk from an investment perspective, starting with a seemingly simple question: what do we mean by 'risk'?

### Deep versus shallow risk

There are various ways to define investment risk, many of which are calculated using formulae that look suitably intimidating to the uninitiated. Beta, Sharpe ratios, the Treynor Index, Value at Risk, R-squared – there are many tools at our disposal to measure the quantitative risk of an asset or portfolio with pinpoint precision.

But there are qualitative aspects of risk that can't always be captured accurately through numbers or standard deviations. We therefore think it's important to take a step back and look at risk more holistically.

Our investment objective is to preserve and grow the real value of clients' wealth. We do that by targeting returns that stay ahead of inflation over the long term, while avoiding large, irrecoverable losses along the way.

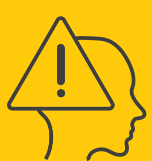
According to financial theorist William J. Bernstein, an investment loss has two crucial dimensions: magnitude and duration. How big is the loss and how long will it last? He claims the combination of these factors determines whether a portfolio is exposed to 'shallow' or 'deep' risk.

### Hindsight is 20/20

Investors in the midst of high-magnitude losses often have no indication of how long the situation will last. Let's look at two examples with very different outcomes.

Some asset classes saw inflation-adjusted losses of up to 70% during the 2007–09 peak of the global financial crisis, but these had mostly reversed within five years. For most investors who held their nerve, the risk turned out to be relatively shallow.

Compare that with the bursting of the 1980s bubble in Japan. Between 1990 and 2013, a period of nearly 25 years, large-cap Japanese stocks had a return of -58.2% in real dollar terms. In the words of Bernstein: "Now *that's* deep risk."[1]



Shallow risks are temporary, involving manageable losses that recover relatively quickly. For example, financial market malaise may cause equity prices to drop for weeks, months or even a few years. This is undoubtedly uncomfortable for investors, but these risks can be effectively managed with the right approach.

Deep risks can lead to high-magnitude, long-duration losses. These are the large, irrecoverable losses that we referred to earlier. Bernstein describes four macroeconomic and geopolitical causes of deep risk: hyperinflation, prolonged deflation, government confiscation of assets and devastation (such as wars).

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The probability of these events occurring are small, but they pose an existential threat at the portfolio level and so cannot be ignored.

An individual investment faces deep risk if its price falls and never recovers. This could be due to corporate corruption or fraud, such as the Wirecard and Enron scandals, which precipitated sudden price collapses and, ultimately, bankruptcies. Competitive disruption may also leave a company's goods and services obsolete, a situation seen at Blockbuster and Kodak.

However, if an asset is sold after its price falls, this crystallises any losses that could be recovered during a rebound. It is self-inflicted deep risk.

In our Chicken Little example, the falling acorn was a shallow risk. Overreacting to it exposed her to the deep risk of a famished fox. Similarly, investors who misinterpret shallow risks may open themselves up to more serious, potentially permanent, losses if they act too hastily.

Of course, we're not suggesting shallow risks should be ignored either. It's important to keep in mind that shallow risks can naturally evolve into deep ones. Tumbling acorns could very well be the first warning sign that an oak tree is about to fall on your head.

### Responding to risk

Distinguishing shallow risk from deep risk isn't always easy. Our hardwired risk assessment systems are a complex mix of impressive biological and psychological responses, but they're far from perfect.

[1] *Deep Risk: How History Informs Portfolio Design, William J. Bernstein, 2013*

The amygdala is the first line of defence. It's a small bundle of cells near the base of the brain that kickstarts our fight, freeze or flight response. Designed to react immediately and instinctively to threats, the amygdala is the reason why you would probably jump in fright if you thought you saw a snake next to your foot.

A couple of seconds later, when the rest of your brain had caught up, you would likely feel embarrassed about overreacting if that snake turned out to be a stick. And yet, resisting our biological risk response systems is incredibly difficult. For obvious reasons, our brain takes an 'act now, think later' approach to survival.

Naturalist Charles Darwin once put this to the test while visiting his local zoo. He conducted an experiment in which he stared from a short distance at a venomous puff adder enclosed in a glass box.

Darwin vowed not to flinch when the snake lunged at him. He failed, even though he knew the snake couldn't actually reach him from behind the protective glass.

"As soon as the blow was struck, my resolution went for nothing, and I jumped a yard or two backwards with astonishing rapidity," he later reflected.

"My will and reason were powerless against the imagination of a danger which had never been experienced."[2]

Even when the higher-functioning parts of the brain are given more time to shine, people still struggle to measure risk accurately. According to Ropeik, this is due to specific 'fear' factors that affect how we assess the severity of a risk, further widening the Perception Gap.

An investor's ability to gauge risk can be further clouded by cultural influences, with the media being particularly influential in framing public perceptions of key issues.

### Market bubbles and froth

Bubbles have been a hot topic in recent months. Readers of our last *Quarterly Letter*, 'Straying from the Herd', may remember that we talked about how fear and greed can encourage the sort of risky investment behaviours which lead to bubbles.

In the months since, market noise about bubbles has reached fever pitch. Google searches for 'stock market bubble' hit their highest levels since 2004 earlier this year.[3] The GameStop saga between short-selling hedge funds and Reddit's army of retail investors has no doubt contributed to speculation, but talks of bubbles had already been simmering for some time.

### Fear factors

Every investor looks to approach risk as objectively as possible. However, homo economicus – a human who always makes perfectly rational financial decisions – doesn't yet exist outside of a textbook.

People are far more affected by external factors than they might think. In *How Risky Is It, Really?*, Ropeik summarises some of these outside influences:

1. **Trust**: Do we trust what we know about a particular risk? If not, we may underestimate or overestimate a threat based on prior assumptions.
2. **Control**: How much independent control do we have over a risk? A lack of control makes situations or choices appear more hazardous.
3. **Uncertainty**: Risk aversion is more common during times of uncertainty.
4. **New versus familiar**: A new or novel threat is often considered more dangerous than risks that we are accustomed to.
5. **Risk versus benefit**: The bigger the reward, the more likely we are to downplay the risks.

Ropeik's book focuses on risk management decisions in a broader sense, but it's not difficult to see how these factors can play a part in investment decisions.

US tech stocks, bitcoin and corporate bonds have all been under the media spotlight, and a January 2021 Deutsche Bank survey found nearly 90% of investors believed price bubbles were prevalent in markets.[4]

So, are fears of bursting bubbles warranted? Or is it simply everyday froth from talking heads?

For our part, we think the term 'bubble' is often overused and incorrectly applied. We also don't spend too much time trying to predict exactly when the next big bubble will form (or burst). It is enough to know that dramatic market downturns will always happen and it's often a shock when they do, although many analysts may claim to have seen it in the tea leaves all along.

There is a lot of luck – and thus risk – involved in trying to buy and sell assets at the ideal time. Bernstein perhaps summed it up best when he said, "Mistiming the market is probably the most frequent and severe form of permanent capital loss."[5]

[2] *The Expression of the Emotions in Man and Animals, Charles Darwin, 1872*

[3] *Wall Street Journal, 'Markets Look Like They're in a Bubble. What Do Investors Do Now?', 31 January 2021*

[4] *Reuters, 'Almost 90% see market bubbles in Deutsche Bank investor survey', 19 January 2021*

[5] *Deep Risk: How History Informs Portfolio Design, William J. Bernstein, 2013*

As we know, a permanent capital loss falls into the deep risk category. Investors who regularly trade in and out of the market continually expose themselves to this risk.

We believe a more sensible approach to risk is to balance portfolios in a way that offers prudent growth when times are good, while also providing reasonable protection for when markets take a turn for the worse.

Rather than commit to a rigid asset allocation in our portfolios, we prefer the flexibility to choose any assets that we believe are priced attractively and help us to meet our long-term objectives.

To this end, our portfolios comprise a mix of return and diversifying assets.

Our return assets aim to deliver long-term growth. As regular readers of the *Quarterly Letter* will know, we favour a 'bottom-up' investment approach, focusing our attention on strong, robustly managed companies and funds that have the sustainable competitive advantages to perform well over the long term.

Risk management is firmly embedded into this equity selection process. We only invest when we have a high level of confidence in our understanding of a business and its underlying value.

Predicting the future is often futile, so we instead spend our time analysing companies from every possible angle to better understand whether they are resilient enough to withstand the economic downturns and competitive threats that we know will eventually occur. In other words, our response to deep risk is deep research.

If we are correct in our long-term view of a company, then day-to-day market fluctuations in prices only constitute shallow risk, and may even provide further opportunities to buy where appropriate.

Similarly, we avoid regions, sectors and markets that we don't understand and can't value.

The fixed income market is an area where we are showing an abundance of caution at the moment. In December 2020, Bloomberg reported that 27% of the world's investment grade bonds offered sub-zero yields, only slightly below a 30% peak seen in 2019.[6]

A negative bond yield means investors receive *less* money at the bond's maturity than the original purchase price. Any investor looking to preserve their wealth over the long term can see how this scenario poses problems.

Meanwhile, one of the roles of our diversifying assets is to act as a form of portfolio insurance, which is designed to offset the worst effects of unexpected market downturns. Diversifiers may seem like a drag on performance when equity markets are booming, but they can offer crucial downside protection in a crisis.

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As investor and fund manager John Templeton once said: "It's impossible to produce superior performance unless you do something different from the majority."

We are aiming for superior performance over the long term, delivering reasonable returns with an acceptable level of risk, while ensuring we have the systems and processes in place to counter factors that could feed a Perception Gap.

**The spectre of inflation**

Chicken Little isn't the only tale that can teach us valuable lessons about risk. One of Aesop's most popular fables, The Miser and His Gold, also provides insights into wealth preservation.

In the story, a rich man reduces all of his wealth down to a single gold ingot, which he buries in a hole in the ground. Every day, he digs up and admires his treasure, before returning it to its hiding place, refusing to spend or invest it.

However, a thief watches the man go through this daily ritual, finds the gold and steals it. The miser laments his loss, but his neighbours are less than sympathetic to his plight.

"Here is a stone," they say. "Throw that in the hole and visit it each day, for it will serve you just as well as your gold did."

What's the moral of the story? Well, it almost goes without saying that the miser could have benefited from some diversification! But it's primarily a cautionary tale to warn people that wealth is wasted when it isn't put to good use.

*[6] Bloomberg, 'World's Negative-Yielding Debt Pile Hits $18 Trillion Record', 11 December 2020*

Investment carries risks, but even stashing money under the mattress (or in a hole in the ground) isn't risk-free; inflation is a stealthy thief. It won't steal away all of a family's wealth in one fell swoop, but it insidiously erodes purchasing power bit by bit.

Remember Bernstein's four macroeconomic causes of deep risk? Hyperinflation was one. And while hyperinflation is extremely unlikely in developed economies, even moderately elevated inflation levels can result in poor real returns across multiple asset classes over longer periods of time.

We are always alert to these dangers, and there are currently reasons to be cautious. The pandemic has disrupted international distribution chains and caused many business and factory closures.

Hundreds of millions of consumers have been locked down throughout the world, with months of pent-up demand possibly being unleashed once restrictions are fully relaxed. The money supply has also increased due to massive government stimulus to support businesses and households during the crisis.

These are some of the ingredients we might traditionally see in a recipe for rising inflation. But not necessarily. Five years after the 2008 financial crisis, in a *Quarterly Letter* titled 'An Inflationary Tale', we wrote:

**"We don't know when the rate of inflation will rise, or how high it will get – economists may try, but this is impossible to forecast accurately."**

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It's a statement we still stand by. At the time, global governments had embarked on large-scale, experimental expansionary monetary policies, including massive quantitative easing initiatives. Then, as now, the spectre of inflation hung over investors.

While the risk failed to materialise in the years following the credit crunch, we nevertheless always stay vigilant, as inflation is unlikely to remain just an ethereal threat forever.

## Conclusion

Risk is an unavoidable aspect of investing. Assessing that risk and reacting accordingly is made all the more difficult by a perception gap, which is often fuelled by mixed messages from our biological, psychological and cultural risk-response systems.

Our investment approach aims to cut through the noise. We build portfolios on a preservation-first basis, with a balance of return and diversifying assets that is designed to avoid the deep risks that lead to large, irrecoverable losses, while also providing prudent growth opportunities.

## Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.