Now you see it, now you Don't!

By Joao Frasco, Chief Investment Officer, STANLIB Multi-Manager

I have always loved magic. Initially as a child because I truly believed that the magician possessed powers beyond the physical world. Then as an adult because I knew this wasn't the case and loved the challenge of solving the problem of how "it was done".

More recently as an investment professional, I'm fascinated by how our psychological and behavioural biases allow us to be so easily "fooled" by magicians, and in turn how magicians have come to learn how to do this. The latest research shows that magicians can simulate throwing a little red ball into the air, and how people will actually see the ball where there is none.

What does any of this have to do with risk? Keep reading and it should all become clearer.

Now imagine that you have just witnessed some magic, as a member of the audience at a performance, and you are trying to figure out how the magician has "tricked" you. When a magic trick is performed in a small group, someone in the audience will always ask the magician to repeat the trick again. The reason for doing this, is that we would like to view the magic from a different point of view. Perhaps not literally by moving our position relative to the magician (although invariably someone always wants to stand behind the magician), but rather by focussing on different aspects of the magic.

One of the magicians "tools of the trade", is to get you to focus on one of his hands, by looking at it himself, while doing something important with the other hand right "under your nose" without you seeing it. We have evolved, as social animals, to follow each other's gazes, as the gaze could represent a source of danger.

Now imagine that, not only could you ask the magician to repeat the trick, but you could move around and view it from different angles and perspectives, perhaps even stepping inside the magician and seeing the magic from his point of view. Could this assist you in understanding the "magic" of the trick?

Risk is unfortunately analogous to a magic trick. There are many views of what risk is and what it is not, and it often depends on your point of view. This, in and of itself, is not an issue. Diversity in thinking about risk is a wonderful thing, just as diversity in our everyday lives is wonderful. The issue that arises in risk management however, is when people start believing that risk is only "one thing", and more problematically, that it is their thing i.e. ***their*** definition or view of risk is the only valid view of risk.

Many asset managers, for example, believe that "risk is the permanent loss or impairment of capital", not knowing or recognising that investors or clients may have very different requirements, goals or objectives. Let's consider just two views of risk that will help us to understand the many facets or faces of risk: risk as loss; and risk as uncertainty.

Risk as loss

To be clear, this is actually risk of loss i.e. that some event causes loss of some kind. In investments, a simple example is the loss suffered by an investor in a bond (essentially a loan to the issuer of the bond e.g. a company), when the issuer defaults on the repayment of the coupons (interest) or the redemption (original capital invested). It is not the daily/weekly/monthly movement in the price of the bond, which may reflect investors' views on many different factors that affect the price of the bond, but rather, the actual loss suffered. This distinction is important in developing our understanding of risk. The daily fluctuations in the price of the bond, essentially reflects two unknowns (derived from hundreds or thousands of other unknowns which we will not cover here); the probability of a loss occurring; and the size of the loss if one were to occur. Once an actual loss has occurred it is no longer an unknown, as its probability and amount is certain.

From the above, it may become clear that the risk of loss is uncertain before it has occurred. It cannot be otherwise. This is what makes the above view of risk problematic i.e. that loss can only be established after the fact (ex-post). Even this risk has to have uncertainty ex-ante (before the fact), which will manifest in price fluctuations. It is therefore naïve to conclude that these price fluctuations do not represent risk in any real sense. It is certainly completely true that the loss may never occur, and hence that the price movement does not reflect an "actual" loss, but unfortunately, even this interpretation is naïve and problematic, and I'll explain why.

While it may be true that an underlying event (representing the risk) has not yet occurred, the value of the asset has presumably changed to reflect that the risk has perhaps changed (holding all else constant). Now, if the value of the asset has changed, then so has the value of your investment, unless you choose not to follow market-to-market accounting principles. Even if you decide not to "crystalise" this loss by selling the asset, the value of your asset has dropped and this should be reflected in the value of your investments (a loss has occurred).

Not doing so is analogous to an ostrich that buries its head in the sand in the face of danger (a form of risk) in the belief that the risk has gone away just because it can no longer see it (which is incidentally just a myth). Not recognising that a loss has occurred does not change the fact that a loss has occurred.

If you are still not convinced, consider an investor about to retire and wishing to buy a pension when the value of his investment has dropped by say twenty per cent. It will be of little consolation to the investor that the loss is not "real" because the underlying securities are still intact as there has been no "impairment of capital", and the market is merely overreacting. The investor who has to sell these assets to purchase a pension will know just how real the loss is.

Risk as uncertainty

Even if the "loss of capital" represents a valid ex-ante view of risk, we still need to recognise that the uncertainty of this risk will manifest in fluctuations in the prices of assets to reflect this risk. The criticism often cited against this latter view of risk is that the fluctuations in prices far exceed the actual underlying fundamental risks of the assets, but this is also somewhat naïve and I will explain this by using a simple example. For the example to be simple, I need to make many simplifying assumptions, so don't bother tearing down this "straw man".

Most people know that the "appropriate" amount to bet on some random outcome, is the expected winnings (ignoring prospect theory that losses "hurt" more than the "pleasure" of equivalent gains). For example, if someone were to offer you a dollar if a fair coin is tossed and lands on heads, you should be prepared to offer fifty cents to take the bet because the probability of a favourable outcome is fifty per cent. But what if the probability of the event is not known upfront? Let's assume that the coin is not "fair", and you don't know the odds beforehand. Obviously you could assume that the coin is biased against you, but let's assume you are allowed to choose heads or tails upfront so as to remove this issue.

Would betting ten cents, or ninety cents be wrong? Can you answer this question **before** the coin is tossed? Can you answer it **after** the coin is tossed? If your answer to either of these questions was "yes", you would be wrong. Making this assessment before the coin is tossed is impossible because you don't have the information required i.e. the probabilities are unknown, and this should be intuitively obvious. It is important to understand that I'm not making the point that this wager should be taken, but rather that one cannot say that any particular value is "wrong" as it would require a "right" value, which is unknown given the lack of information.

While this will be intuitively obvious to most people, most people will not recognise that making the assessment after the coin is tossed is also not possible, as this is not intuitive (after all, we have now observed the outcome and success or failure). This requires a more thoughtful explanation.

Assume that I now tell you that the probability of success was twenty per cent. Now you know that the "correct" amount to wager would be twenty cents, so betting ten cents would be a great strategy as your expected winnings are positive. This does not depend in

any way on how the coin landed as this is the outcome of a random event. Similarly, if you now assume that the probability of success was only 5 percent, betting ten cents would be a terrible strategy as your expected winnings are negative, again independent of how the coin actually landed.

You therefore cannot know whether a strategy is good or bad, before or after a random event has occurred, because it had a probability between zero and hundred percent before the event occurred (unknown) and then either occurs or doesn't occur (known). Yet, the industry continues to assess managers' investment decisions based on the results they achieve, and assume that the managers with great performance have great skill, and those with poor performance have little or no skill. The reality is far less simple.

Now, this doesn't mean that the same assessment cannot be made after many repetitions of the coin toss. Eventually, the probabilities of the coin coming up heads or tails will become apparent. This information can then be used with confidence to decide on a winning betting strategy.

Unfortunately, this need not be the case in asset management, because while the coin doesn't change over time, asset managers are changing every day. People change and philosophies and processes evolve. Even if the asset manager remains exactly the same over time, the world around them keeps moving forward, changing everything else in its wake.

So where to from here?

With this understanding of risk, which admittedly is simple but already nuanced, how do we go about managing risk? I'm hoping that an understanding of the nuances, will make the solutions a little clearer. Investing is by necessity a risky endeavour. You need to take risk to get rewarded for it, but you shouldn't be taking risks that will not be rewarded.

Investing with a company that is developing some new product that many people will want to buy is risky because the endeavour may fail (at many different points), but this risk may be worth taking because the return may be great if it succeeds. Investing in a company that intends to defraud you would never be a good idea because you should never expect a positive return. You therefore need to consider and understand which investments and which risks you can expect to be rewarded for, and only invest in these.

In the last edition of Mindset, we wrote extensively about diversification as a "free-lunch". It is not the best description of diversification. A better description would be to describe ***NOT*** diversifying as taking unrewarded risk because diversification is easily acheived. Yet investors often take many unrewarded risks, admittedly often without realising that they are doing so. Choosing a single asset manager to manage all of your assets would be a great example of this. There is no one on the other side of this investment "paying" you to take this single manager risk i.e. it is unrewarded. Even if you choose not to invest in a multi-manager solution which will diversify that risk away for you, you should be spreading your investments over multiple managers.

Unrewarded risks come in many different forms, and investment risks are only a small subset of all the risks that investors are subjected to when investing their hard earned wealth. Instead of covering all of these risks in more detail here, I want to focus on just two that are often overlooked or given too little emphasis, but form a fundamental component of our overall risk management process.

Understand what you are buying

Many problems stem from a lack of understanding. This lack of understanding can be caused by many different things. Sometimes products are simply too complex to understand, and sometimes they have just been poorly communicated (which we will come to in the next section). It is incumbent on investors, intermediaries and portfolio managers, to understand what they are buying before committing their own money, but even more so when they are committing other people's money. This is definitely an unrewarded risk, and one that no one should be taking. ***If you don't understand it, don't invest in it.***

At STANLIB Multi-Manager, we spend a lot of time with asset managers (and on our own in technical workshops) to understand the very complex environment in which we operate. We are extremely

privileged to manage other people's money, and we take on this task with a great sense of responsibility. We work tirelessly to ensure that we understand the risks that we are taking in the pursuit of returns for our clients. This is not about removing or mitigating risks, as this defeats the purpose of investing. It is about removing unwanted and unrewarded risks, and appropriately pricing other risks to ensure appropriate compensation for the risks taken. You cannot do any of this if you don't understand the environment in which you operate, from capital markets to the managers that invest in them on our behalf. Picking managers based on their past performance is simply irresponsible because it violates everything discussed above, but the market is unfortunately filled with people prepared to do this, for themselves and for others.

Communicate what you are selling

We have another important responsibility in managing other people's money, and this involves facing our clients/investors. It is not enough to create great solutions that will provide great returns, if we fail to clearly communicate with our clients. Where we have developed bespoke solutions for our clients, we have spent a huge amount of time in the process of understanding their requirements (sometimes years, as we partner for very long periods when building solutions for decades to come). This makes communication easier as we have had time to develop a common lexicon and understanding. This is however not possible when you create solutions for the retail market where individual investors will buy your solution alongside hundreds of others, either with or without advice.

It is therefore important to make a concerted effort to explain the solution, so that investors can make informed decisions (tying back to the section above on understanding what you are buying). It brings me great sadness to see investors' anguish when markets produce negative returns and investors see their wealth drop precipitously. It is of little consolation to them that this is the reality of investing. Wealth is created over the long term by investing in risky endeavours through the careful consideration of capital allocation. It is therefore important to explain this all upfront, in clear and simple language. It is unfortunately not a simple task as you have to deal in all sorts of complexity that plague capital markets. To think that this is easily solvable is again naïve, but that doesn't mean that it is futile and we push ahead every day in trying to do this a little better than the day before.

Following on from the theme of this article, one of the most important elements to focus on is the communication of risk. Whether it is through fact sheets and minimum disclosure documents, or through road shows, or through one on one engagements, we use every opportunity to explain what an investor should (and equally important, should not) expect from our solutions. While many risk proxies like "volatility" have many limitations and can be problematic in many situations, this should not stop us from using them in helping to explain the risks inherent in solutions. Using many different metrics and explaining them in clear and simple language will provide at least some insights into how the returns of the solution may evolve.

Conclusion

Risk is many different things to many different people, and while I have focussed on a couple of dimensions which I think are important, my primary objective was to highlight the "risks" in taking a single point of view or too narrow a point of view.

Understanding the complexity around such a small and simple word should provide pause to even the most seasoned investment professional. Risk in investing should be embraced as it represents the potential for great reward, but it needs to be understood that not all risks are rewarded, and that these unrewarded risks should be banished from solutions.

So perhaps I can end by challenging anyone who has followed this article all the way to the end, to metaphorically step out of your shoes, and step into your clients' shoes, or an asset managers' shoes, and consider other points of view when considering risk. You may find that if you do this, the "magic" and "risk" of investing will begin to be revealed to you.