

The Value of Good Brakes

4th Quarter 2021 Letter

November 17, 2021

A first principle for compounding returns is managing **RISK**. We admit this is a topic that needs a good analogy. Therefore, we are simplifying this concept of risk using sports car racing.

We are not car enthusiasts. But after watching the true story movie ***Ford v Ferrari***, we came away with a fresh appreciation for **BRAKES**. Brakes are to car racing, as risk management is to investing.

To follow along, please take a minute and watch this clip: [Ford v Ferrari - Brakes!](#)

On complex racetracks like Le Mans, does the team with the biggest engine win races? We argue the driver with the best **BRAKES** wins. But at the end of a race, does the announcer talk about the brakes? Of course not.

Brakes are dull and uninspiring. Similarly, it is hard for us to recall the last discussion of risk management on CNBC or Bloomberg TV. But brakes and risk management are critical for success – around racetracks or in the pursuit of compounding returns.

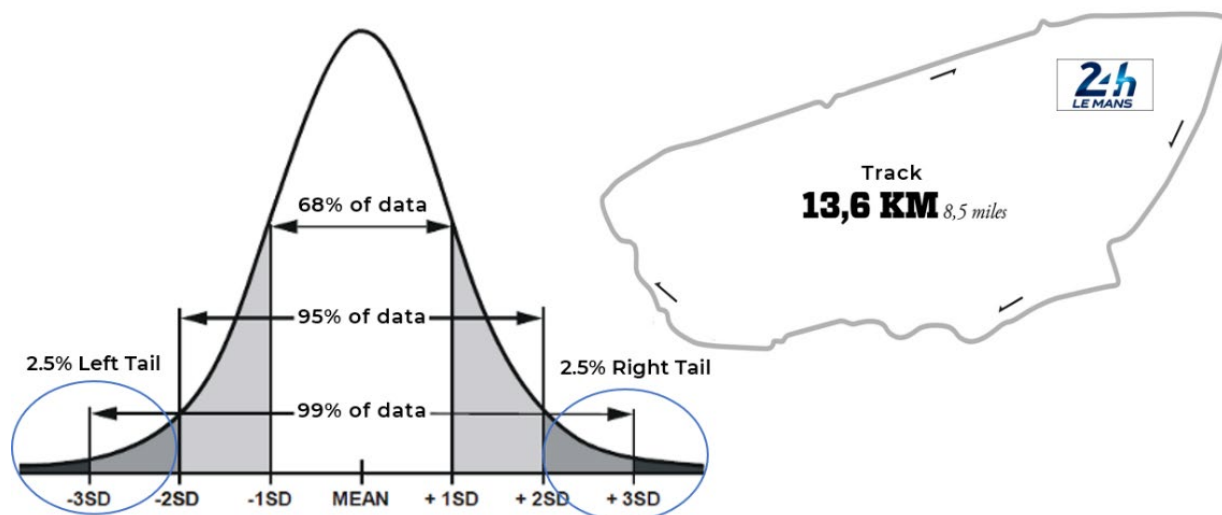


Today, we sense that the average investor is driving with poor brakes. This includes both amateurs and professionals. If the brakes fail, perhaps investors expect monetary authorities to push them back onto the track. And that is a rationale we have heard from professionals. But to us, investing in a fashion that depends on government help is a dangerous way to compound returns.

What *is* Risk?

In sports car racing, risk takes the form of unexpected incursions by other cars, poor track conditions, and tight turns. Investment risk also takes many forms—and there are different ways to define it.

Let's start with the investment industry definition. Professional investors express risk in quantitative terms: **volatility**. Volatility, or standard deviation, is a yardstick of dispersion around an average return, price, or valuation ratio. This measure of risk takes the shape of a **bell curve**. Large deviations from the average may point to the prospect of higher returns, but not always. If this statement was true 100% of the time, volatile investments wouldn't be risky.



This industry definition has many shortcomings. Simply put, volatility is volatile and hard to forecast. Howard Marks at Oaktree Capital expressed the shortcoming with this quote:

*"The probability of loss is no more measurable than the probability of rain.
It can be modeled, and it can be estimated (and by experts pretty well),
but it cannot be known."*

And real-life investment risk is more complicated than mathematically maximizing return for a given level of risk. But the cornerstone of modern portfolio theory is totally grounded in it.

Portfolio theory may indeed account for risk most of the time, or, say, 95% of the bell curve distribution. But what about the 5%? The 2.5% in the right tail? The 2.5% in the left tail? For our purposes and reference, the left tail represents cheap assets and the right tail expensive assets.

Like poor brakes in tight turns, portfolio theory can fail when you need it the most - in the tails of the bell curve. For example, the Global Financial Crisis was a right-tail failure of modern portfolio theory.

Next to the bell curve illustration above is the Le Mans, France, racetrack. We think it is fair to say that 95% of the Le Mans track consists of straightaways, and 5% are tight braking turns. If brakes and portfolio theories fail in the 5% tails, what risk management techniques mitigate these failures? Application forthcoming, but first, we need a practical definition of investment risk.

While the bell curve is simple, real life is not. Sometimes, large losses occur in the right tail, and large gains happen in the left tail. What is a real-world definition of investment risk that captures this reality? Over the years, we've collected definitions of risk from people smarter than us. This is our favorite from Elroy Dimson of the London School of Business -

"Risk means that more things can happen than will happen".

We interpret this to mean that there is always a range of possible outcomes: unexpected bad and good things can happen. This definition also embraces our humanity. We don't know the future.

Just because we don't know the future doesn't mean we cannot prepare. We do know that 95% of the racetrack—market environment—consists of straightaways. We argue the key to success is managing the 5%. Tight turns with brakes—extreme markets with judgment.

Similarly, managing investment risk doesn't mean riding the brakes — just the opposite. Without good brakes in tight turns, there is no finishing the race. Good brakes allow you to accelerate in the straightaways. With good brakes, investors are freer to accelerate when appropriate.

Closing out our analogy, recall from the clip that the 1966 Ford Team changed the entire brake assembly in the middle of the race. Swapping out the brakes helped Ford win the 24 Hours of Le Mans in 1966, 1967, 1968, and 1969.

Investment Application

In short, no matter which valuation yardstick you choose, the S&P 500 is in the 2.5% right tail – extremely expensive! The charts in the appendix illustrate this point. While valuations are not a precise timing tool, they give you broad strokes of risk levels. With prices this high to history, we believe the risk level is high.



We entered this year modifying our brakes—risk management. Speculation and frothiness have reached an ominous level – S&P 500 valuations are still a significant concern. But the government just reported US inflation of 6%, a thirty-year high. Now, we are checking all the high-risk boxes for the S&P 500.

In addition to short duration-high quality bonds, managed futures, cheaper global equities, we added a gold exchange-traded fund across accounts in the 3rd quarter to hedge inflation risk. It's impossible to predict the pin that pops this high-profile asset bubble, but we have to be prepared for a range of outcomes.

With this change to our brakes—risk management, we believe that our strategy is prepared for tight turns so that we can accelerate in the straightaways.

We would be remiss if we didn't wish you and yours a Happy Thanksgiving! We appreciate having you as a client and a friend.

Very truly yours,

A handwritten signature in blue ink, appearing to read "Scott A. Roads".

Scott A. Roads
Founding Principal

A handwritten signature in blue ink, appearing to read "Julia E. Zaino".

Julia E. Zaino
Principal

P.S. Don't miss the appendix for additional asset price charts.

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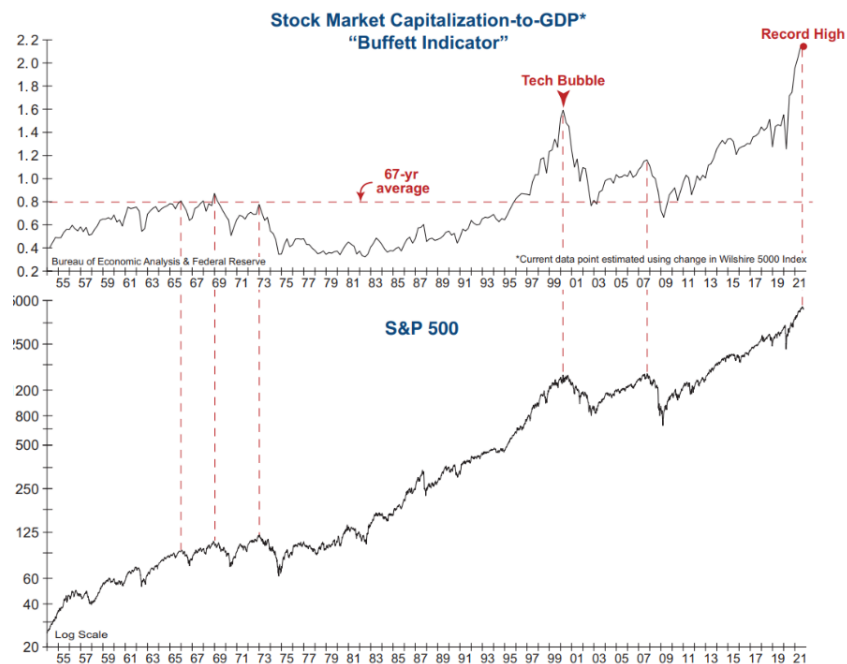


Special Recognition

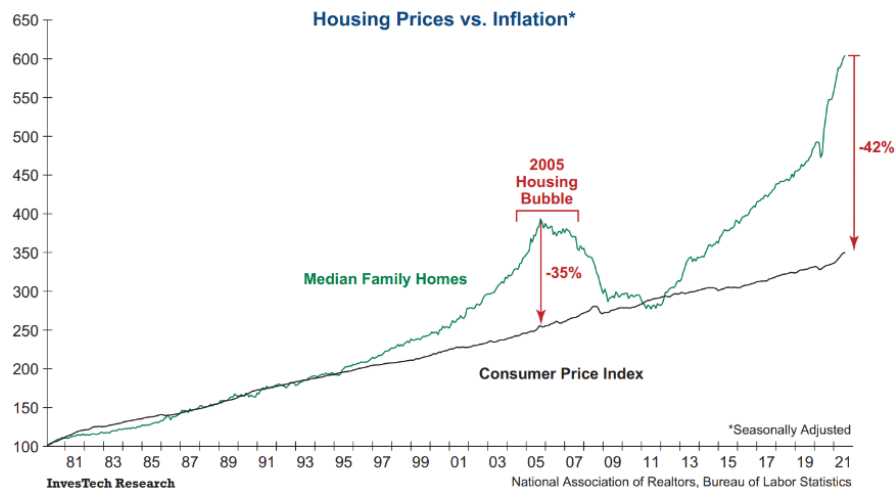
We want to recognize David Dredge of Convex Strategies in Singapore. We adapted his brakes analogy in a derivatives context, to our asset management setting. We really enjoyed his “participate and protect” discussion with Grant Williams. <https://www.grant-williams.com> <https://convex-strategies.com/>

Appendix

- A. Stock Market Capitalization -to- GDP. This is the popular Warren Buffett Indicator.
Credit: InvesTech.

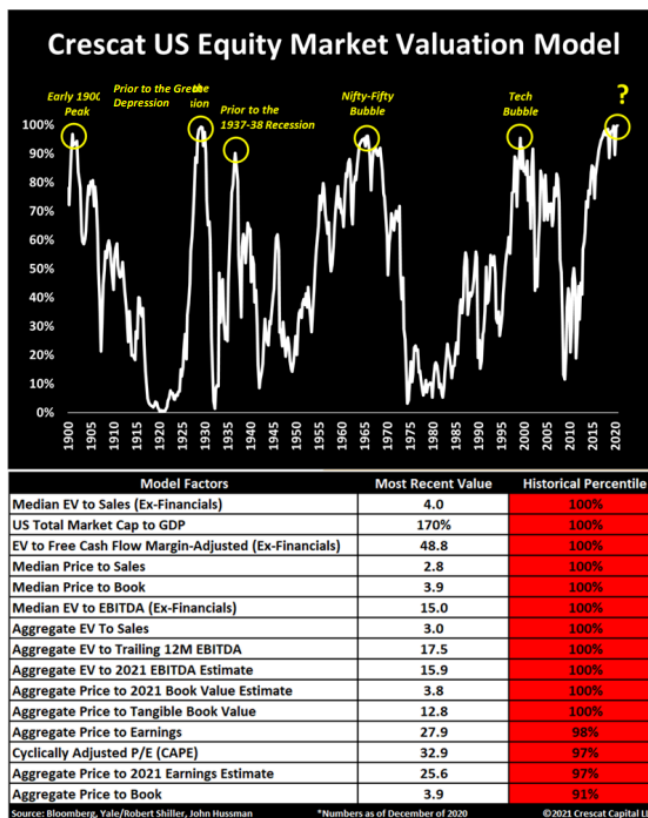


- B. Housing Prices vs. Inflation. Credit: InvesTech Research





C. Various valuation yardsticks of the S&P 500. Credit: Crescat Capital Macro Presentation
<https://www.crescat.net/>



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