36 South Views

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As a portfolio manager of any traditional description, the ultimate goal is to maximise the terminal wealth of one’s portfolios under management.

This is measured by the compound annualised geometric return (CAGR). At least we should measure this way as arithmetical returns distort the reality.

There are only two ways to maximise this number… Maximise returns and/or minimise losses.

Both are important but I would unequivocally say (and it’s not my view but mathematically proven) that minimising losses is more important to terminal wealth than maximising gains. The reason is simply the volatility drag or volatility tax.

I.e. a loss of 50% is not the same as a 50% gain because it requires a 100% gain just to get back to square. Getting big wins are not nearly as important as minimising big losses.

I apologise to most readers for ‘lecturing birds on flying’ but here is the paradox.

Why do we spend 90% of our time as portfolio managers maximising returns rather than minimising losses when it can clearly be shown mathematically to be more important to the terminal wealth of a portfolio?

The reason is hiding in plain sight….

Human nature….

In football the strikers are the glory players (and the best paid) whilst the midfield and backs are basically polyfilla.

In golf, everybody loves a long hitter of the ball (Bryson DeChambeau, John Daly) and we often tip them to win at the bookmakers. But it is the players who are accurate at that least sexy distance of less than 100 yards, and even downright boring distance of less than 10 feet, who end up invariably holding the Cup.

In nearly every sport it is the same … attackers seem more important to winning games than defenders.

Finance, game shows, TV dramas are just the same. We are drawn to the heroic-at-all-cost, devil-may-care pathways. We choose to roll the dice even if the odds are against us rather than avoid the dice altogether.

But statistics tell the truth, the teams with the most balance between offence and defence fare better. Portfolios with correctly structured risk mitigation end up with a higher terminal value.

Yet we persist in ignoring what is in plain sight. It is our nature. Our cognitive blindness.

As portfolio managers, we hold erroneous assumptions which support our basic erroneous nature…

We say to ourselves…

Diversification is the best we can hope for.

Negative carry products can’t help the terminal wealth of a portfolio.

We will time the market.

Clients won't blame us if the portfolio is down 50% alongside the S&P but we won't hear the end of it if the S&P is up 20% and we are only up 12% because we mitigated some risk. This part is true unfortunately, but it is the client's human nature not the PMs.

But as in life (and finance)… to the thinker go the spoils…. at the end.

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