

BY RICHARD "JERRY" HAWORTH

Analogy – Ferrari vs Rally Car

My good friend David Dredge has a wonderful analogy comparing the accumulation of capital to a Formula 1 race.

Basically, it goes like this...

Most drivers in this race have cars with only accelerators and no brakes. The boldest go fastest and if they don't crash, they win....

Aggressive managers chase performance only, the poster boy of this approach has to be Elon Musk.

The more conservative drivers (portfolio managers) go slower, they have a more conservative diversified portfolio of bonds and equity and whilst crashing less often, they rarely win races.

Advisors abound... they say they know the track well and will guide you, telling you when to slow down and when to speed up. They get paid on average speed of the car... if you crash, they reset the fee earning clock and invariably advise to go full speed ahead in the next section.

Buying tail hedges as the analogy goes is like buying disc brakes for your car. It helps you brake harder into the corners (less losses) and gives the driver the confidence to go faster on the straight as they know they have the braking power.

The brakes add weight to the car and thus adversely affect top speed. A drag race would always be won by the car with the boldest driver and no brakes.

I have mulled over this analogy a lot and really like it.

However, like all analogies, it seems to only approximate the compounding wealth dilemma.

Then it struck me like a thunderbolt.

The Formula 1 analogy assumes a KNOWN track which is studied in advance and can be anticipated.

The reality is different and it is due to unknowns... uncertainty. What we don't know we don't know.

Uncertainty is the mortal enemy of compounding through time. As Mark Twain said, "It is not what you don't know that gets you into trouble. It is what you know for sure that just isn't so".

It is assumed that the track is well understood and well known. There is an illusion of high control and high certainty (an illusion ably assisted by central banks).

We are wired to embrace this illusion, for optimism and overconfidence in our knowledge of the track.

This is not reality.

A better analogy, from my point of view, is that compounding wealth is like a race. Time is an incredibly important element but not a Formula 1 race.

It is more like an off-road rally in terrain unknown to all the drivers (and advisors).

The drivers know their cars and their capabilities. The terrain is a combination of off-road and on-road (risk off and risk on). In mountainous terrain, the corners are treacherous, life threatening and often accompanied by fog and mist.

In this environment, there are old drivers and bold drivers but NO old bold drivers.

In this environment, brakes are essential. Where the next corner is and how sharp it is, is unknown. Ditto when the fog of uncertainty and war descend on the terrain.

In this environment, there are long stretches of straight asphalt so accelerating and engine power are also critical.

In this environment, the cars with big engine power and good brakes with Automatic Braking System (tail hedges which kick in automatically) will thrive.

On the straight, the cars with no brakes will thrive. In the corners, they will hit unexpected corners and slid into the ditch. If not fatal, they will spend days, months, years sitting in the garage waiting to be fixed, losing invaluable compounding time. The Nikkei 225 has yet to come out of the garage after 30 years.

The rally cars, with powerful engines and powerful brakes, will have the capacity to go fast (albeit a bit slower than the previously mentioned cars) as they have the weight of the braking system onboard. They come into their own when the terrain turns more uncertain, into dirt roads, sharp corners, fog and mist. It is here that these rally cars (with capable drivers) pick their way through the uncertainty at the safest permissible speed. When they emerge onto an asphalt straight again, they are way ahead of their competitors who languish in the garages getting fixed.

The latter will never catch up in the compounding race.

Finally, this year has ended and I hope you and your family have enjoyed a peaceful and joyous Christmas and New Year.

Disclosure

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