REFOCUS

PORTFOLIO MANAGER MONTHLY - JULY 2019


Piet Viljoen

This document describes our thinking behind selected recent portfolio management actions in our portfolios and provides context to their current positioning against the backdrop of their investment opportunity set. Our funds always consist of a diversified portfolio of opportunities and risks; please bear that in mind when evaluating our commentary about individual positions.

In space no one can hear you scream

In Ridley Scott's classic movie Alien, the hero is a solitary space traveler who encounters an alien. This is terrifying on two levels – the protagonist is completely alone and its adversary, the alien, does not follow what we would regard as "normal" rules of engagement.

All of life's engagements are governed by sets of rules. These rules define what counterparts can and can't do. Laws, rules and regulations reduce uncertainty, so that role players know what is expected of them. We find comfort in a system where we understand the rules. In the movie however, the alien is not only incubated by - but also eventually hatches from - the hero's stomach! And this is just the start of the confrontation. The uncertainty created by an environment which exists far outside of our set of accepted rules of behavior makes for truly terrifying viewing.

Compounding this horror is the fact that our hero has to face this terrible situation entirely on her own. Human beings are herd animals, hard-wired to feel safer in groups. The tagline of the movie: "In space no one can hear you scream" – clearly speaks to our inherent fear of isolation.

Often, that's exactly how we feel about being invested in the stock market. The stock market is a hive of risk and uncertainty. Our investment decisions are made in an environment which does not adhere to a fixed set of rules, where surprising things happen all the time. Companies issue profit warnings and their share prices go up. Highly respected CEOs turn out to be frauds. Businesses with otherwise good reputations waste shareholders' funds on expensive acquisitions in foreign jurisdictions. At precisely the moment when investors agree that nothing can go wrong and all invest accordingly - it can, and it does. And so we learn that in the market, there isn't any safety in numbers. Instead, we are vulnerable, fearful and alone. In the market, no one can hear us scream.

Most investors' first call, when faced with these circumstances, is for increased regulation. Did the CEO sell his stock before the profit warning? Make a rule prohibiting such transactions. Was the CEO a fraud? Increase corporate governance regulations. Was the IPO a dud? Call for better disclosure rules. And so on.

Following this train of thought, one can't be blamed for asking why it isn't possible to come up with a set of rules that eliminates risk and uncertainty completely. But standard economic theory states that in a world of perfect competition, in which all economic agents have complete knowledge, people will make purchase and production decisions that will lead to zero profits. Profit pools exist where there is imperfect knowledge, where uncertainty reigns. Uncertainty is a cost of doing business, and creates profit pools to act as incentives for economic agents (read: entrepreneurs) to act on. Taking advantage of this uncertainty can create a lot of value – for instance, retailers reduce search costs and banks reduce credit costs.

If increased regulation causes less uncertainty, it follows that this also leads to a stifling of incentives to innovate, leading to worse outcomes for the economy, and ultimately, the consumer and the investor. It should be no surprise then that economies with relatively high levels of government intervention (i.e. high regulation), also have poor GDP growth, higher poverty and less choice for consumers. This directly impacts the earnings power of corporations - in a negative way.

The harsh truth is that increased regulation is not the answer - like the protagonist in "Alien", you are on your own when it comes to protecting yourself. But instead of calling for more rules and regulations, we would propose that investors apply two far more useful tools to protect themselves against adversity: diversification and a margin of safety.

Diversification helps us deal with the inherent uncertainty embedded in the market by allowing us to make that simple statement that is so difficult for us to admit: "I don't know". The result of being able to admit to "not knowing" is the ability to build a portfolio consisting of as many uncorrelated outcomes as possible. If the individual outcomes are appropriately sized, such a portfolio will be relatively stable, and generate satisfactory returns – whatever the future holds. Of course, the corollary is that we have to accept that some of these positions will turn out to be wrong, but this is when position sizing is important. If one works off the premise that you "don't know", it is hard to justify a huge position in anything. Importantly, when one or more of these diversified positions underperforms, it does not destroy the overall portfolio.

Tool number two is a "margin of safety": the difference between the share price paid, and the underlying fundamental value of the business bought. If, at the outset, we have paid a lot less than what the asset is fundamentally worth, even in a bad outcome we are unlikely to lose a lot of money. But in a good outcome, we can make a lot of money. Again, this tool helps us deal with "not knowing" what the future holds by providing us with some downside protection if we turn out to be wrong, while stacking the odds in favour of substantial upside if we turn out to be correct.

So, while it is true that in space no-one can hear you scream, in the market things need not be so scary. All we need to do is use these two simple tools effectively enough such that screaming is no longer inevitable.