

An Illiquid Lunch

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Feedback loops camouflage under different names in the domains of science and business. In physics for example, chain reactions are feedback loops where a reaction creates products which in turn allows additional reactions to occur. This self-reinforcing pattern is responsible for many important reactions that have shaped the modern world, the most famous of which is the nuclear chain reaction which nuclear power plants use to generate electricity.

In the business world, feedback loops exist as network effects and are responsible for creating some of the most successful companies in the world. Network effects exist when each extra addition to a network benefits everyone one else already on the network. Examples of this can be found in Amazon, Facebook and Microsoft.

While the two examples above point to the positive effects of feedback loops, these can also turn negative under the right conditions. Anyone watching HBO's historical drama – Chernobyl, will appreciate the risks of uncontrolled nuclear chain reactions.

During a deflation or a bank run for example, an expectation of events to come is often the catalyst that causes the event to occur in the first place. Economic deflations are an example of negative feedback loops. Falling prices during a deflationary period compels people to put off purchases in anticipation of lower prices in the future. This however causes businesses to lay-off staff which creates a cycle of higher unemployment, lower demand for goods and services and lower prices. Similarly in a bank run, a strong, well capitalised bank can fail simply because people believe the bank will fail causing them to withdraw their deposits.

A bank run of sorts is currently occurring in the Woodford Equity Income fund. We do not own the fund now nor have we ever owned it in the past. The fund holds a lot of illiquid assets in the form of unquoted companies which are difficult to sell if clients request their money back. The fund has had a period of poor performance which has led clients to withdraw their money. However, since the fund owns a lot of illiquid assets, it has struggled to meet client redemptions and this week, it finally decided to suspend trading in the fund meaning clients can't get their money out.

The unholy alliance of poor performance and illiquid holdings is a risk that most people do not consider when selecting investment funds. Once stuck in the whirlpool of a negative feedback loop, it is very difficult to escape. However, it is much easier to simply avoid the rough seas entirely.

Throughout our nine-year history at Tacit, we have avoided holding any asset which has a low underlying liquidity such as open-ended property funds and absolute return funds. We have a strong negative filter when making investment decisions and good underlying liquidity is one of the variables we focus on which our peers often deem irrelevant.

By simply applying a strong negative filter to our process, we reduce the probability of a poor outcome which naturally increases the probability of a good outcome. As Charlie Munger said, "All I want to know is where I'm going to die so I'll never go there".

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