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Avoiding the noise

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How should we quantify risk when investing; is it the risk of losing money? Or, maybe the risk of not achieving our financial goals? Or the risk of preserving our buying power over the longer term in the case of a pension?

The reality is that risk exists only in the future and it is impossible to know what the future holds. When we view the past no ambiguity exists; those things that happened, happened. But what about those things that didn't occur that we worried about and guarded against? A default by the UK government or Scotland voting for independence.

Ultimately, investment is about considering all potential outcomes that you can think of and trying to hold investments that you believe are least likely to be affected negatively should any of these events (scenarios) occur. The basic fact is that there is as much chance of something that we do not envisage occurring as there is of any outcome we foresee.

One of the ways to protect against such 'known unknowns' (to coin a phrase from Donald Rumsfeld) is to focus on current valuations and yields. The valuation of an asset, both absolute and relative, is a guide to whether investors are being greedy or fearful at any point in time. The yield is an indication of the certainty of a level of return should all other things stay equal. Absolute valuations are measured using fancy ratios such as price to earnings or EBITDA (earnings before interest, taxes, depreciation and amortization for those that are interested). But what about relative valuations and yields?

To us, relative valuations were difficult to gauge during the decade before Covid struck and even more so for the period directly after Covid as interest rates were manipulated by central banks to keep the world economy running. Now however, valuations and yields are providing a very helpful guide to investors about what risks they need to take to generate positive real returns.

The best way to consider this is that cash currently provides a return of between 4% and 5%. If I am willing to tie my money up for ten years, a government bond in the UK provides a return of 4.34% (less charges for holding). If I am willing to accept some credit risk, then I can buy basket of bonds issued by global businesses providing a yield of 8%. In this context, the 8% return seems a solid investment for the relatively low risk of lending money to a diversified selection of over 300 companies for the next few years.

Lending money to the UK government for ten years does not appear to be such a solid investment when the cash rate is currently higher than this. Why lock up my money for ten years for a lower return? But what if the investment landscape changes and interest rates return to 3%. In such an environment the government bond is a better investment than holding cash.

Investment is ultimately about the price you pay for something today and its potential to protect you against future events and scenarios. None of us have a crystal ball but to us, the yields available (around 8%) on bonds issued by global businesses provide a solid balance between the certainty of income return and the potential risks in the world today. Whilst most investors are focussed on the political events both here and across the pond, at Tacit we continue to focus on the current valuations of the assets in client portfolios, both in absolute terms but as importantly in relation to each other. We are actually feel comforted by the investments we hold for clients in an evolving world order.

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