

Focus on cashflows rather than politics

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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? Remember the worries of a default by the UK government or the Scottish 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 valuation. 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. 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?

To us, relative valuations at present are very difficult to gauge. The best way to consider this is that cash currently provides a return of 0.25%. If I am willing to tie my money up for ten years, a government bond provides a return of 1.39% (less charges for holding). If I am willing to accept some credit risk, then I can buy a bond issued by Vodafone providing a yield of 2.5%. In this context, the 3% return seems a solid return for the relatively low risk of lending money to a company like Vodafone for the next ten years.

But what if the investment landscape changes and interest rates return to 2%. In such an environment the government bond is likely to move to a yield of 3% and the Vodafone bond to a yield of 4% (all other things being equal). Should an investor now need to sell this bond to buy another investment or for unforeseen circumstances, its price will have fallen substantially (by 10-20%).

Whilst most investors are focussed on the Brexit negotiations and the Conservative party leadership, 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. The political environment in the UK could affect the prices of assets in the short term, however, it remains vital to hold assets that have 'real' underlying cashflows which will not be affected by the outcome of the negotiations over the coming year.

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