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Perception and reality

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When investing you can focus on two types of risk: volatility and the risk of a permanent impairment of your capital.

Volatility often refers to the amount of uncertainty or risk related to the amplitude of changes in an investment's value. A higher volatility means that an investment's value can potentially be spread over a wider range of values. This means that the price of the investment can change dramatically over a short time period, either up or down. A lower volatility means that an investment's value does not fluctuate dramatically and tends to be more steady. Volatility, whether high or moderate, is an ineluctable dimension of investment, and is to be embraced and managed with understanding.

Very simply, the risk of a permanent impairment of capital means that investors should worry less about day-to-day price swings but worry much more about, insolvency risk, asset valuations being written down on the balance sheet, and outright failure from which there can be no recovery.

Over the past decade, we have been asked many times why the Tacit approach to investing is risk averse when compared to many of our investment competitors. This misguided perception that we are unwilling to take investment risk stems from our clear delineation between the two types of assets we utilise in our strategies: those that can make money in real terms (Growth) and those that preserve capital in nominal terms (Stabilisers).

When investing, we focus closely on the risk of a permanent impairment of capital first and intentionally do not try to manage day-to-day volatility this applies equally to the Growth and Stabiliser components of our strategies. For example, owning long duration government bonds when they were yielding below 1% increased the likelihood of an impairment in the future and therefore we did not own these in the run up to September 2022. Our aversion was based on a conviction that a turn in the interest rate cycle would eventually come and that bonds priced with yields so out of line with the historic norm would fall to levels from which they could not recover. The perception of the risk that we take does not actually match the reality, however. We take risk, but only where the odds are stacked in our clients' favour. The measure of this is illustrated clearest in the chart below.

Source: Morningstar Workstation, as at 31st May 2024

All Tacit strategies have generated better returns over the past ten years (illustrated by being higher in the chart). This however has not been achieved by taking less risk when measured by volatility. If this was the case the Tacit strategies would be to the left hand side of the peer group whereas they're actually to the right hand side and therefore exhibiting higher volatility. This demonstrates statistically that we have taken more risk than our peers as measured by this metric. A further consideration is that, unlike many professional investors who favour higher volatility investments, this is an outcome of our investment approach rather than a driver of our decision making.

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