

Russian Roulette

Published on: 24 July, 2020 | Author: Investment Team

The Russian author Leo Tolstoy noted in his novel, *Anna Karenina*, that all happy families are alike whereas each unhappy family is unhappy in its own way. The same can be said for investing, admittedly without the flair of Tolstoy; All good investment decisions are alike whereas all bad investment decisions are unique in their own way.

All good investments, in essence, try to minimise speculation about something that is unknown and fundamentally unknowable. Imagine if the government said it was offering £1 million to a hundred people to play a game of Russian roulette. If you survive, you get to keep the money and if you do not, it goes back to the state.

About 5 out of every 6 people i.e. 83% or 83 people in total will survive and become millionaires. Some of them will brag to their friends about the “trick” they used to beat the game. Others will author books and give TED talks on winning strategies in Russian roulette. Some of the more quantitatively minded participants will even calculate the probability weighted return which is about £833,000 and argue that the only “rational” option is to take the bet since it has a “strong risk reward profile”.

The winners are of course, simply lucky. This is not a tirade against luck; better to be lucky than not. However, you should not count on luck since by definition, luck is random and good luck is simply a random event in your favour.

Why is playing Russian roulette to win £1 million a bad idea? From the initial outcome, it certainly seems like a good idea. For the winners at least. It is, however, a fundamentally bad idea because if you play long enough, it becomes a mathematical certainty that you will die. All your Russian roulette returns drop to zero and you lose all optionality to play the game in the future.

Good returns in an investment depend on two factors: the earnings yield (inverse of the famous price to earnings ratio) and growth. If you buy a property to rent it out, your return is the sum of the rental yield plus appreciation of the property value. The speculation comes from question marks on the yield and growth. How sure are you that you will get your rental income paid on time and in full? And how sure are you that the growth will come?

So, you have two factors that determine returns: the current earnings yield plus growth. The yield part of the equation is what most traditional value investors focus on i.e. how much am I getting today for investing in the company. The growth part of the equation is what the growth investor focuses on. Speculation enters into the equation because the earnings yield may not be as reliable as claimed, as we have seen recently with some statistically cheap sectors like financials and oil and gas which continued to become even cheaper. Likewise, the growth may not be reliable as has been seen for many growth stocks throughout history.

And herein lies the wit and wisdom of Tolstoy in that eerily simple but profoundly true quote that “all happy families are alike whereas each unhappy family is unhappy in its own way”. All good investment strategies rely on a combination of reliable earnings yield plus reliable growth to achieve returns. All bad investment strategies have a dogmatic focus on either yield or growth for its own sake.

Simply buying the highest yielding or fastest growing companies, disregarding how reliable said yield or growth is, can often work over short periods of time. After all, the majority of people that play Russian roulette once will survive.

Every day, the market gives all participants the opportunity to play a game of Russian roulette. Many investors feel the need to take the market up on its offer of potential quick gains. Our strategy at Tacit remains to keep risk management at the forefront of any decision we make. Avoiding the terminal bullet is more important than winning the outsized gains on a turn of the barrel.

Important Information: Any views, insights, or commentary are for general information only, do not constitute personal investment advice or research, and are intended for UK residents. They may not be appropriate in all jurisdictions. While sourced from information we believe to be reliable, we make no guarantee as to accuracy or completeness. Past performance is not a guide to future results, and the value of investments can go down as well as up.

Regulatory Disclaimer: Tacit Investment Management is the trading name of TIML Limited (No. 9228395), part of Tacit Holdings Limited (No. 10611211). Both companies are incorporated in England and Wales, with the registered office at 14 Hanover Square, London W1S 1HN. TIML Limited is authorised and regulated by the Financial Conduct Authority (FCA ref. 670184) and approves and issues this communication under Section 21 of the Financial Services and Markets Act 2000. Please note, tax and estate planning services are not regulated by the FCA.