Where Chance Meets Risk and Beyond

Saturday's With Jim

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Dear Friends,

Morgan Housel, one of our favorite bloggers, recounted the failure of more than 80% of German reserve tanks when called to duty at the battle of Stalingrad in late 1942.[i] Several months of inactivity gave mice a chance to crawl into the tanks wiring, gnawing the insulation away to make nests for themselves. In Donald Rumsfeld's famous words, "It's not the known unknowns that blindside and hurt us, it's the unknown unknowns, things we are most unlikely to predict." Following Rumsfeld's reasoning, it's not the inevitable bear market which should cause us angst – there are well known strategies to survive them. Rather, we should be more concerned with how we organize our work to provide redundancy in case one or more of our routines should fail to function properly.

Manageable Risk

When I moved my residence to Brazil in 2004, for example, I made sure to have a wire line phone in addition to a cell phone in case the power went out (which it frequently did then) or in case lightning scorched any of my computer equipment (which it did once). The wire line wasn't dependent on an Internet connection or the electrical grid. For some time now, not only have I maintained a wire line phone, which I can use to call out, I have two Internet connections – one a backup in case my primary connection fails. This said, the communication precautions I have taken are responses to known unknowns, knowing that my communication setup could fail but not knowing when it might go off line. How could we (Gaia staff) be replaced quickly and proficiently if the need arises? Our upcoming business affiliation in the next few months - not a merger - with Sowell Management Services, a firm with over $1 billion under management, resolves succession issues because Sowell can proficiently assume any or all of our money management and record keeping tasks.

Much chance-related risk can be assumed without great loss, prevented with adequate preparation or transferred to a third party, as in insurance policies. Investment risk, though, is another matter.

Investment Risk

Investment risk can be transferred to a third party (equity-linked insurance), but at a high fee which may cancel its benefits. Most often, investment risk is assumed by the investor, though it can be mitigated by careful attention to detail and unemotional execution of a carefully crafted investment policy. Investment risk can be lowered (probably with lowering of returns) by holding less risky securities and by diversifying across groups of securities which move in different directions from one another (uncorrelated). The major, hard to mitigate source, of investment risk arises from the quality and the frequency of decisions made to form and adjust portfolio composition (buy and sell securities). Decision risk is greatest when emotions get into the investment process (emotion-driven decisions are almost always opposite of what we must optimally do). Each time we tinker with your security holdings, especially when making sweeping changes, we introduce risk that did not exist if we had just done nothing. This said, risk is often accompanied by return, so a blanket denunciation of decision or tinkering would be inaccurate. Risk also enters when the reasons behind decisions are flawed. For example, if long-term investors make decisions based on short-term market moves, unless they are believed to be longer lasting, they might find themselves whipsawed – the condition adjusted for is ephemeral and soon in need of another adjustment.

Wrapping Up

Chance risk, as shown above, can be fairly easily removed as a source of great angst. Investment risk, though, is here to stay because it is part of the investment landscape (inherent in investment choices) and is deeply embedded, as we are all emotional and herd-following human beings. This said, with careful preparation, a solid investment plan/policy and emotions under guidance, you can enjoy the benefits accorded to long-term investors – exponential growth after about 15 years.

Thank you for investing with us.

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[i] Housel, Megan. "Nobody Planned This, Nobody Expected It," May 9, 2018
http://www.collaborativefund.com/blog/nobody-planned-this-nobody-expected-it/