Scenario-based investing and the management of risk

Anet Ahern

Anet has over 25 years' experience in investment and business management. After starting her career at Allan Gray in 1986, where she fulfilled various roles in trading and investment management, she worked as a portfolio manager at Syfrets, and later BoE Asset Management, where she was CIO and CEO. She also spent six years at Sanlam, where she was the CEO of Sanlam Multi Manager International, with assets totalling R100 billion in local and global mandates. Anet joined PSG Asset Management as CEO in 2013.

'Luck is the residue of design.'
Branch Rickey, as quoted in 'The Outsiders' by William N Thorndike

In an ideal world, failure would not be an option

Many years ago, well before emails were the norm, I was preparing for my first CFA exam. On the Friday afternoon before we were due to write, I received a telegram that was as terrifying as it was encouraging, depending on your point of view. It was from my mentor and boss at the time, and it simply stated: 'Failure is not an option. Best of luck.'

When it comes to the stewardship of our clients' money, we are well aware that in an ideal world, we would be dealing with total certainty on every decision we make and our conviction would be matched by the reality that ensues. We would never get an investment wrong – failure would not be an option. In fact, many investors are yearning for someone who can make sense of an often chaotic world, and ensure that their hard-earned capital is safe, and that it grows. Investors want to be told what is going to happen, despite all evidence weighing against the predictive talents of the vast majority of market commentators and forecasters. This need puts investors at risk of falling for false promises.

The harsh reality is that as investment professionals we deal with opinions and probabilities

In fact, I have heard the x-factor of top fund managers being described as the ability to measure and combine probabilities successfully even if they cannot explain these probabilities. Ultimately, as identified in the book 'The Outsiders' (which describes traits of eight unconventional but highly successful CEOs), it is the manager who can allocate capital effectively that will stand out over time. As custodians of our clients' capital, any investment decision boils down to a delegation of the allocation of that capital across many opportunities.

As for opinions, not all opinions are equal in quality, and that is where a consistent and thorough research process comes in. We firmly believe that an opinion backed by fact and thorough analysis is infinitely more valuable than a fleeting assessment, no matter how well 'sold' and presented.

The key lies in finding the balance between facts and quality opinions

In a portfolio of investments, we are juggling the probability of a number of outcomes, some of which we may be more certain of than others. For example, if the government borrows money from you over 12 months at a specific interest rate, you can be quite certain that you will be getting your money back with interest. You will also make less than 10%. However, if you invest in a certain unknown stock with scant financials and no history to speak of, the outcome is a lot more uncertain. You could make well over 100%, or lose it all. Somewhere on this spectrum of certainty and having no clue at all, lies the responsible mix between fact and opinion – the measured probability that can find its place into the portfolio.

At PSG Asset Management, we only invest in securities that we can value. And we are only able to value securities for which we are prepared to predict a range of potential cash flows from the investment. Our conviction in the cash flow, which is typically a function of the company's moat and management, determines the discount rate that we use to value the security. If we find it too difficult to value or truly understand a company, we walk away from the opportunity.

Buying cheap shares has its limitations

There are many one-dimensional or formulaic moneymaking recipes. And one recipe that may well work in the very long run is to only buy stocks that are cheap – especially on a low price-earnings ratio with a high return on capital. Sounds good, doesn't it? Buying cheaply and sticking to companies that understand the concept of return on capital.

Even though this approach sounds great, it doesn't work once patience starts running out. It can require painfully long periods of tolerating underperformance and holds the risk of value traps – shares that just remain cheap or get cheaper. So we have to find a way to remain true to our investment philosophy while at the same time operating within a framework that will not inject undue risk into our clients' investments.

We truly consider alternative outcomes
Anyone who has life insurance has in some way considered at least one alternative outcome to the future they have planned. We cannot insure against all outcomes, but what we can do is to consider several scenarios that will lead to different outcomes and be prepared for these scenarios.

One way we do this is to always consider the bear case – what if we are wrong? For passionate, enthusiastic and naturally optimistic investors this is way out of their comfort zone. We do not confuse energetic expression with passion and dedication. For us, it is the sober consideration of a range of outcomes that will lead to a better decision. We determine a most likely or central scenario on which we build our valuation, and then build out alternative outcomes, including some rather unlikely scenarios as well. It is only when we have thoroughly considered all of these avenues that we can establish a target price and a margin of safety in the event that our central scenario does not play out.

We take this a step further by spelling out how we will know that our most likely scenario is no longer playing out by identifying milestones, signs or events that will warn us to reconsider our initial thesis with a totally open mind. This is one way of avoiding denial and stubbornness in the path to building conviction in an investment view. Removing emotion from our assessment and process is invaluable.

We consider a wide range of options in detail to eliminate the bias of our investment ideas
We have on several occasions changed our minds about an idea that we've put our research heart and soul into, because of the evidence stacked against our carefully crafted investment proposition. This highlights a common trap that highly dedicated analysts can fall into – clinging on to their investment of time and effort when the investment idea itself needs to be abandoned. Our process of looking at the different outcomes in painful detail aims to remove this bias, along with its close companion, denial. For instance, a scenario under which we would sell a company with a great track record and that does not seem overvalued could play out as follows: when the industry or market conditions within which a company operates change structurally, compromising its competitiveness, we revisit and revalue. New entrants with a structurally lower cost base would be a classic example of this. Another example is a technological shift that changes the behaviour of customers – a case in point is how online shopping is changing the face of retail, especially in the UK.

It is not enough to consider this range of outcomes on an individual investment level. On a portfolio level we also have to look at the impact of alternative scenarios on the portfolio as a whole, and make sure that we are not exposing our clients' funds to unintended risks.

We don't have the time or luxury to truly consider a wide range of outcomes in our daily life. When it comes to our role as stewards of our clients' funds, however, we don't have the luxury not to.