REZCO

What risks should investors care about?

By Simon Sylvester, CEO, Rezco Asset Management

Risk can mean different things to different people within the investment world. Traditionally in finance, we talk about volatility being at the core of measuring risk, others might prefer just to look at downside volatility arguing that upside volatility is a good thing that is desired in portfolios. Beta (how sensitive a portfolio or share is to the market index) is also useful, and so to measuring drawdowns and downside capture ratios. Furthermore, how shares, asset classes, or even portfolios interact (or correlate) with each other can impact portfolio risk. Tracking error is also referenced often, a risk metric concerned with how different (or active) a fund's return may be relative to a benchmark index.

So what do investors really care about? **In conversations with clients and advisors over the years, I generally find only two risk factors that really matter to investors:**

1. Losing money (or drawdowns)
2. Underperforming peers or anyone around the braai (tracking error)

Problem #1

Both these metrics are backward-looking. While useful, they should ***not*** be the end conclusion but an input (amongst many factors) into a highly detailed assessment of an asset manager.

Problem #2

Fund investors react ***differently*** to the above two risk factors. Significant drawdowns often occur simultaneously across the industry; thus the pain is shared with commiserations around the braai.

If investors react as follows: your fund has a major drawdown, then stick with it and hope to recover, but if your fund shows relative underperformance then switch…. then risk management is punished with this behaviour, and assets are herded into industry-conforming standards, with collective risk building up into the next big bear market. If you believe markets always go up, then this is a good strategy, if not, then allocating to fund managers that consider risk deeply might be the better route.

> *"Show me the incentive, and I'll show you the outcome."*
>
> Charlie Munger

If avoiding ***relative*** underperformance over a period is the incentive, then the outcome is many funds similar to each other.

The behaviour of the fund industry and the customers of these funds are thus strongly linked: if investors react (switch funds or strategies) only to underperforming peers, but not to drawdowns, then the providers of funds are incentivised to manage relative performance very closely. Avoiding drawdowns takes a back seat to avoiding relative underperformance. Fees and passives come in here, but I won't go into detail in this note.

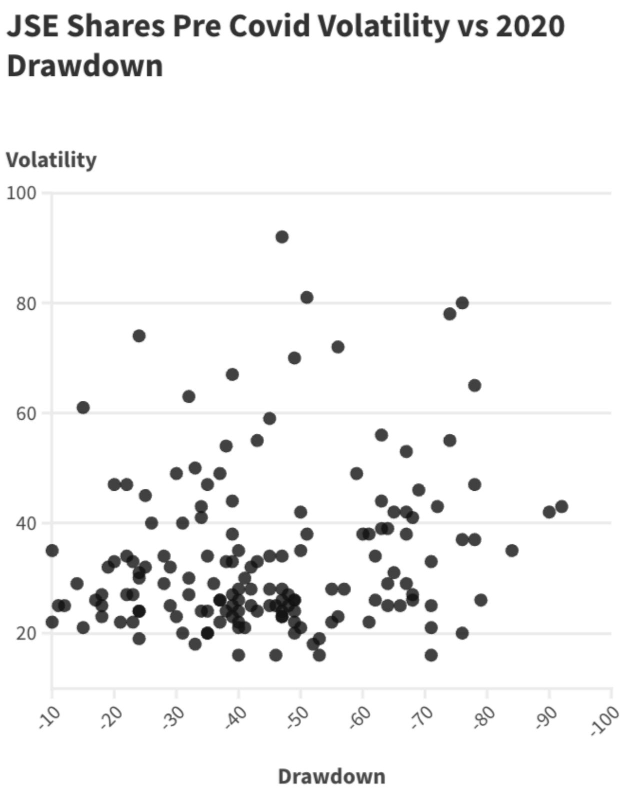
We have always focused on risk-adjusted returns at Rezco, with the aim of trying to protect capital in risky times and generate good growth when risks or valuations allow.

> *In our experience of the South African industry and market functioning, we often find that aiming to manage drawdown risk (protect capital) comes in contention with reducing tracking error. It's difficult to manage both concurrently through time - a choice has to be made!*

In managing risk, we target the following when selecting shares and constructing portfolios:

- Lowering average portfolio Beta - we want to dampen the wild swings of markets
- Selecting assets with lower correlations - good benchmark agnostic diversification that results in portfolios with lower volatility
- Building portfolios that have lower correlation to peers or indices - supporting client's portfolio diversification between funds
- When selecting shares having consideration of the business risk, valuation risks and share price (technical) risk

There are many angles to considering risk, and no single metric is perfect. It's about looking at portfolios and shares from multiple quantitative angles and bringing this together in a portfolio construction process that integrates the quantitative analysis with the qualitative experience of the portfolio managers. This is what we have been doing at Rezco over the past 20 years, and our historic risk metrics support our assertion of managing risk through the cycles.



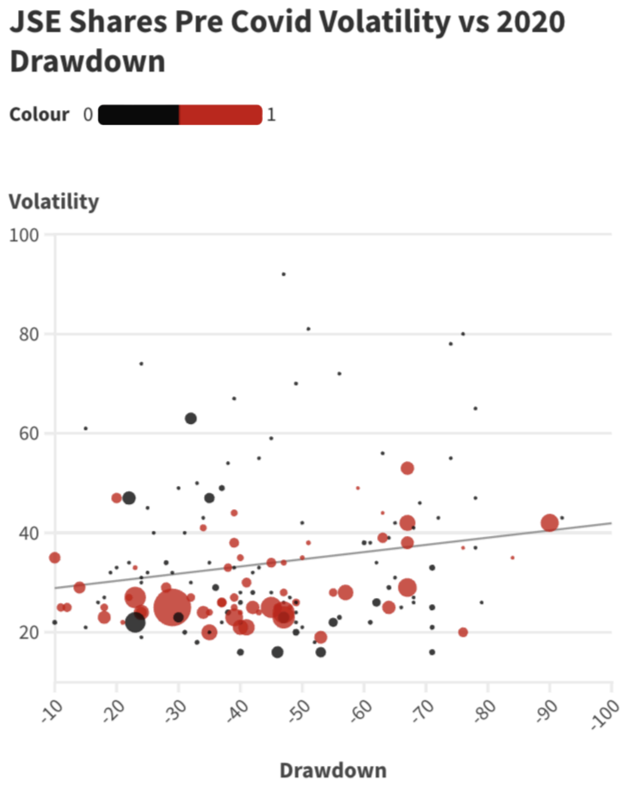
While this note can't go into all the detail, digging into one metric in some detail will hopefully be helpful to readers....

Why is volatility so important?

In a liquid and efficient market, large price moves signal uncertainty - sophisticated investors are grappling with the value of a business, and as data becomes available, the share prices move, with wider moves suggesting greater uncertainty (or risk).

Earlier, I criticised being backward looking; so can volatility signal risk of capital loss and thus be forward looking? In the above chart, I measured the volatility of individual shares listed on the JSE ***leading up to*** the market fall due to COVID-19 in Feb 2020. I then measured each share's maximum drawdown over the months that followed and plotted this on a scatter plot. The idea here is to see whether selecting shares with lower volatility measured before the crash would help the portfolio through the unexpected fall that unfolded. Shares with higher volatility should see higher drawdowns, but that conclusion is not very obvious in the above chart.

Visually it doesn't look like there is much of a relationship in the above chart. The problem with volatility as a risk measure is that it requires liquidity - if illiquid shares do not trade often then measuring risk using share price changes will give, most likely, the incorrect answer by signalling lower risk. Now adjusting the above chart, but highlighting the major SA index shares (ex gold and REITS) red, and sizing the dots according to market cap (proxy for liquidity) results in the alongside version of the chart. Here the red dots have a much stronger relationship showing volatility leading up to Covid resulted in higher average drawdowns through the crash in equity markets over the first half of 2020.



So while Covid might have come as a surprise, had a portfolio been built to target lower volatility, then this would have tilted the portfolio to having a lower drawdown through the crash. Indeed, risk metrics need to be used when they make sense, using volatility for liquid shares in more efficient areas of the market, whereas liquidity risk might matter more elsewhere. Furthermore, a share that has low volatility but has steadily risen as a 'favourite' over time could be carrying substantial valuation risk or share price technical risk becoming overbought. Volatility is one metric to look at, and requires a working knowledge of its use.

As portfolio managers, we always work at the margin; readers would be well aware that good portfolio managers are working with low odds, targeting being right 55% of the time, with the very best getting closer to 60%. In risk management, as in targeting returns, the tools are also imprecise, and rather than targeting a perfect metric, it is about getting the odds in favour.

In Summary

In our experience of managing SA portfolios with lower volatility, we have found selecting companies with lower volatility, diversifying well and using good portfolio construction to lower portfolio volatility has resulted in portfolios that demonstrate lower drawdowns, lower down capture ratios, lower Beta and help clients navigate risky periods of the investment cycle. So, while we may not always be the favourite fund around the braai, we strive to stick to what we say on the can - risk management at the core of what we do and, over time, generating good returns for clients.

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