

## **Risk, Return, & The Essence of Adding Value**

This month, I explore how the relationship between risk and return forms the bedrock of sound (or poor) investment results. I will also demonstrate why the management of these two elements constitutes the essence of adding or destroying value for investors.

## **Good is Not the Enemy of Great: It is Great**

David VanBenschoten was the head of the General Mills pension fund. In each of his 14 years in this role, the fund's return had never ranked above the 27<sup>th</sup> percentile or below the 47<sup>th</sup> percentile.

Using simple math, one might assume that over the entire period the fund would have stood in the 37<sup>th</sup> percentile, which is the midpoint of its lowest and highest ranks. However, despite never knocking the lights out in any given year, VanBenschoten managed to achieve top tier results over the entire period. By consistently attaining 2<sup>nd</sup> quartile performance in each and every year, over the 14-year period the fund achieved an enviable 4<sup>th</sup> percentile ranking.

## **The Hippocratic Oath and Investing**

The seemingly irreconcilable difference between the average of VanBenschoten's rankings and his overall rank over the whole 14-year period stems as much from the performance of other funds as from his own results.

To achieve outstanding performance, one must deviate from the crowd. However, doing so is a proverbial double-edged sword, as it can lead to vastly superior or inferior results. The preceding rankings indicate that most of the managers who were at the top of the pack in some years also had a commensurate tendency to be near the bottom in others, thereby tarnishing their overall rankings over the entire period.

In contrast, the General Mills pension fund, by being consistently warm rather than intermittently hot or cold, managed to outperform most of its peers. Managers who aim for top decile performance often end up shooting themselves in the foot. The moral of the story is that when it comes to producing superior results over the long term, consistently avoiding underperformance tends to be more important than occasionally achieving outperformance. In this vein, managers should take the physicians' Hippocratic Oath and pledge to "first do no harm".

## **Robbing Peter to Pay Paul: The Bright and Dark Sides of Asymmetry**

The Latin term *Sine Que Non* describes an action that is essential and indispensable. In the world of investing, the ability to produce asymmetrical results meets this definition. It is the ultimate determinant of skill.

A manager who delivers twice the returns of their benchmark but has also experienced twice the volatility neither creates nor destroys value. They have simply robbed Peter (higher volatility) to pay Paul (commensurately higher returns). Since markets tend to go up over time, clients may marvel at the manager's superior long-term returns. However, this does not change the fact that no value has been created – clients have merely paid in full for higher returns in the form of higher volatility.

If this same manager delivered 1.5 times the benchmark returns while experiencing twice the volatility, not only would they have failed to add value but would have destroyed it – they would have simply robbed Peter by exposing him to higher volatility while paying Paul less in the form of excess returns. In contrast, if the manager had produced twice the returns of the benchmark while experiencing only 1.5 times its volatility, then they deserve a firm pat on the back. They would have achieved asymmetrically positive results by paying Paul far more in outperformance than what they stole from Peter in higher volatility.

## **The Efficient Market Hypothesis: Why Bother?**

The efficient-market hypothesis (EMH) states that asset prices reflect all available information, causing securities to always be priced correctly and making markets efficient. By extension, the EMH asserts that you cannot achieve higher returns without assuming a commensurate amount of incremental risk, nor can you reduce risk without sacrificing a commensurate amount of return. It argues that it is impossible to consistently "beat the market" on a risk-adjusted basis. When applied to the decision to hire an active manager rather than a passive index fund, the EMH can be neatly summarized as "why bother?".

In most cases, the long-term evidence makes it hard to strongly disagree with the EMH. Most active managers, especially in developed market equities, have failed to add value. According to S&P Global, 85.6% of U.S. active managers have underperformed the S&P 500 Index over the past 10 years. The Canadian picture is almost identical, with 84.9% of managers underperforming the TSX Composite Index.

Given these dire statistics, it's no wonder that swaths of institutional and individual investors have migrated from active management to index/passive investing in recent decades.

## **Theory, Practice, & Yogi Berra**

Baseball legend Yogi Berra stated, "In theory, there is no difference between theory and practice - in practice there is."

With respect to the EMH, I agree that markets are highly efficient, but not completely so. There are times when markets are more likely to deliver strong returns than weak or negative results, and there are times when the opposite is true. Similarly, there are times when certain sectors or individual stocks are likely to outperform others. These contentions need no more validation than the tech bubble of the late 1990s and its subsequent collapse or the global financial crisis of 2008.

Of course, accurately identifying these opportunities ultimately comes down to one's

approach, which according to the S&P Global data above has proven unsuccessful in most cases.