Karim Taleb
Robust Methods LLC
New York

ROBUSTIFYING CAPITAL
(LEARNING BUFFETT'S RULES)

While the founders of family businesses were mostly occupied with building and developing their concerns, heirs today are faced with the challenge of preserving accumulated wealth. It would appear the task of preserving capital is easier than the one of growing it but it could be argued the two are not materially different. They could be considered equally demanding and as dependent as two facets of the same coin.

Whether an early business success came as a result of good entrepreneurship, a good idea coupled with an industrial mind, or just plain luck, does not really matter past this point. What is more important to realise is the invisible hand in the marketplace which gives freely, is the same hand that can also take freely.

The recent decade does not have much to show in terms of broad investment success, except perhaps for some relatively special situations. Having incurred significant losses in many assets and supposedly diversified portfolios, investors find themselves increasingly wary of committing new capital to investments. A renewed focus on preserving wealth and avoiding risky propositions is high on investors' agendas.

Perhaps nobody has summed up investment principles in a simpler way than Warren Buffet:

Rule #1: Don't lose money
Rule #2: Don't forget Rule #1

At first, this cardinal command seems trivial - who would want to lose money? Yet there is more depth to it than its apparent simplicity. Beneath an obvious and self-explanatory directive, lies a hidden gem: retain the option of staying in the game if proven wrong.

According to research findings in behavioral finance, overconfidence is a well documented cognitive bias that investors commit. Many do not give much thought beyond their investment analysis as it pertains to their decision being proven wrong in retrospect. Past the psychological impact and humbling experience that usually follows a poor investment decision, the devalued investor has to relinquish the ticket that put him in the game at a certain economic level.

In the 'negative-sum game' of the financial markets, where just breaking even is by itself a real challenge, retaining the option to reengage is critical and not having one is decisive in eventually being driven out.

Some readers could be familiar with the mathematical reality that an investor who has lost 50% on his first investment will face the unrealistic objective of needing to make a 100% return on his next just to break even. Further, the list of investment proposals which could lose 50% in short order is certainly long and easy to find while investments that promise a 100% gain are few, far apart and carry a commensurate level of risk.

It is worth noting that Buffet's rule implicitly addresses the overconfidence bias by considering at the outset the possibility of an investment decision being wrong. It looks at the game as a multi-stage process versus a single-stage decision - the idea being not to live or die by a single bullet or by the result of a single outcome. Should someone's investment decision be proven wrong, they would at least retain the option of more or less reclaiming the original capital and have another chance at a new investment.

The emphasis on Rule #1 hence is not merely stating the obvious but ensuring the endurance of the capital and the survivability of the player.

One cannot be a successful investor without being a seasoned risk manager first, and where risk management is a necessary condition to good investment success in the longer run.

Buffett's simple investment rule applying regardless whether an investor is seeking capital appreciation or capital preservation speaks to the robustness of the rule. The fact it aims at maximising the survival of capital, most likely at the expense of not trying to maximise the expected value of the investment, further adds to this characteristic of robustness.

Rule#1 is certainly clear to understand, but as Goethe once said "Knowing and doing are two different things." For the willing, forecasting an investment cannot turn sour is easier said than done. Point in case is the relatively recent purchase by Buffet of Goldman Sachs' stock after coming down sharply off its highs. Little did he and his followers expect that the company would be next in line for a serious bungee-jump.

This recent anecdote from a seasoned maestro certainly begs the question as to what extent is it actually possible to avoid risk? Don't we all want to avoid a loss and how is that possible when investment opportunities by definition come with a corresponding level of risk?

We see risk as present in all assets, including currencies and Treasuries, and do not think that it can be totally avoided. Nevertheless risk can be allocated, targeted and even somewhat optimised.

At the heart of our methodology is a tactical asset allocation program which blends a robust risk management approach with an active optimisation of the portfolio's exposure. It aims at containing the downside risk while keeping the portfolio's upside potential open.