INVESTOR LETTER
October 2020

Dear Investors,

We've been asked "why am I not getting higher return despite taking more risk?" Recently, while reading the book "The Most Important Thing: Uncommon Sense for the Thoughtful Investor", I felt that there was a good way to explain this. I might be too optimistic, but let's try.

More risk = More return

How many times have you heard this? It is likely part of a pitch for any investment, be it for bonds or equities. "More risk, more return" has found its way to become a basic principle in investing. Figure 1 pretty much sums it up.

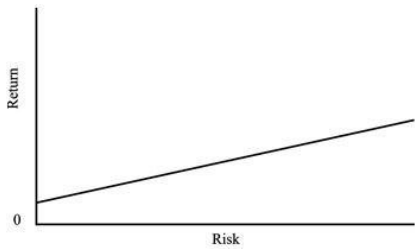

Figure 1 Risk-return chart

This concept is true but oversimplified. If taking higher risk guaranteed higher returns, there would be no risk right? Nevertheless, relying on this simple tenet has resulted in investors drawing conclusions that ultimately disappointed them.

Figure 2 is the version found in finance textbooks. What is the difference?

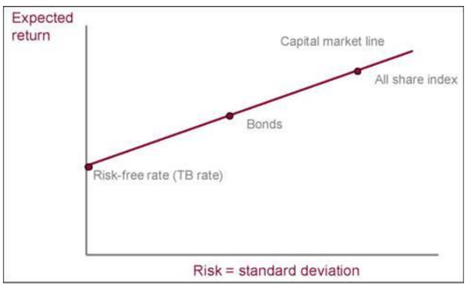

Figure 2 Textbook risk-return chart

For the eagle-eyed readers, you will see the finance textbook says "expected return"; meaning "higher risk, higher expected return". To which I can imagine the reader saying "but of course, my expectations are in line with the risk of my investment!" This is where the trouble begins.

Same risk → More return!

What if I say that you can get more return for the same risk? "Isn't it too good to be true?" one might ask. Actually, one can indeed get more returns from taking the same risk.

Vanguard estimates global equity returns to be between 7-9% per annum[1]. Imagine you had invested into global equities as shown in Figure 3, and compounded at 23% per annum over four years from 2003-2007. That cannot be luck right?

Figure 3 Global equities MSCI ACWI Index Dec 2000-Oct 2007

Same risk → Less return

How about getting less return for a given level of risk? Nobody would expect, much less want that.

After a great run, there was inevitably a bear market which resulted in the compounding rate dropping from 23% to 3% per annum from 2003-2009 (Figure 4), well below the expectation for equities.

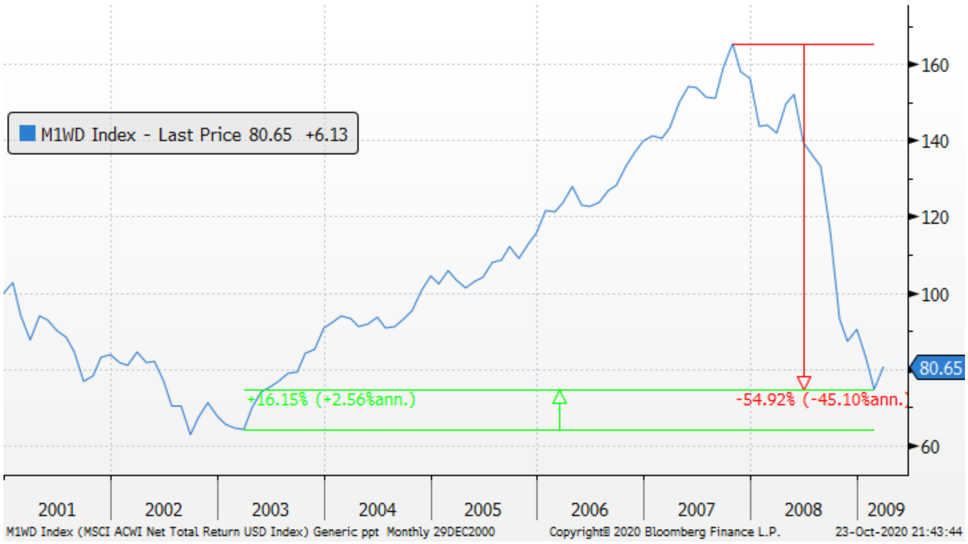

Figure 4 Global equities MSCI ACWI Index Dec 2000-Mar 2009

[1] https://advisors.vanguard.com/insights/article/2020midyeareconomichighlights

Whatever happened to the expected equity returns of 7-9%? Actually, that continues to be the most likely return for an equity investor. That is the basis for taking more risk, that a higher return should be expected. (I emphasise expectation not hope.) The reality is also that higher risk opens an investor to a wider range of possibilities, in terms of much higher or much lower returns. What is comforting is that these much higher or lower returns are less likely to occur compared to expected return (sorry to burst the bubble for those who were momentarily experiencing much higher returns above expectation). Figure 5 is a much more realistic depiction of the very popular risk-return chart. We used the example of equities here, but this is true for an investment at any risk profile such as bonds.

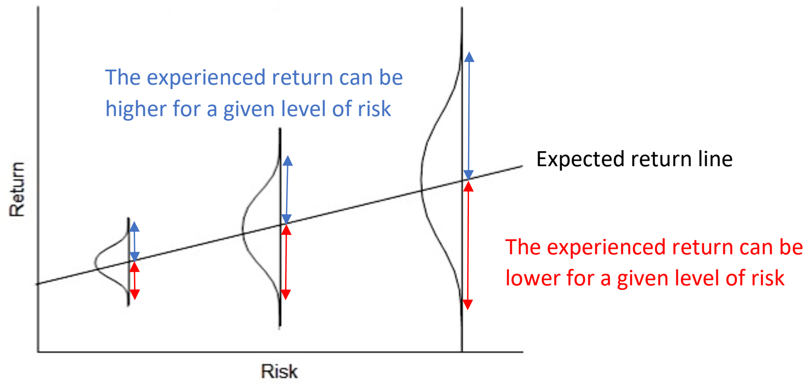

Figure 5 More risk, more possibilities. Source: Oaktree Capital Management

Earlier on, I mentioned that the popular risk-return chart has disappointed investors. There are two possible scenarios for this.

- An investor gets a rate of return higher than expectation, and adds on. The market subsequently declines to revert to the long term expectation. The additional investment suffers a loss, and the investor's compound rate is lower than expectation.
- An investor gets a rate of return lower than expectation, and exits. The market subsequently rises to revert to the long term expectation. The investor locks in a loss without participating in the recovery.

Higher risk → Less return

Now that I've demystified the absolute truth of "more risk = more return", here's another proposition for investors to contemplate. It would likely cause concern and distress for an investor with higher risk profile to experience a lower return than another investor with lower risk profile. For example, in 2014 global bonds were up 7.6% while global equities were up 4.2% (concern?). In 2018 bonds were up 1.8% while equities[2] were down 11% (distress?).

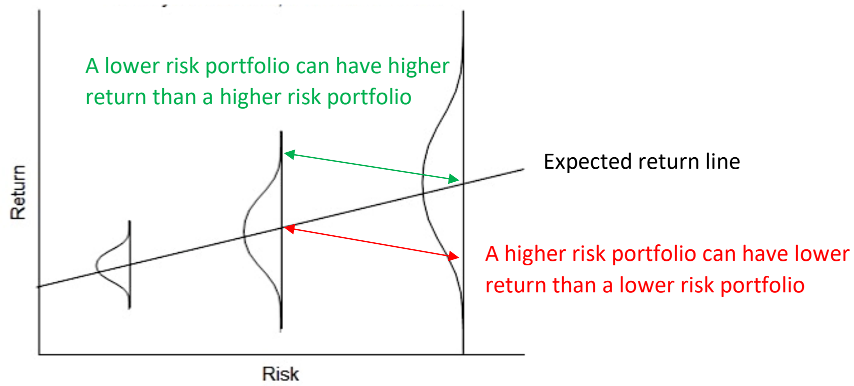

Figure 6 Counterintuitive possibilities

I have to credit Howard Marks for conveying a realistic picture of investing by adding some curves to the standard risk-return chart in his book, "The Most Important Thing: Uncommon Sense for the Thoughtful Investor". Incidentally, the curves indicate that the most likely returns for a given level of risk are at the 'hump', while the higher and lower returns for a given level of risk are less likely to happen (but do happen).

If taking risk cannot guarantee an expected return, what is the point of taking risk? The reality is returns will always move around as a direct consequence of taking risk. If there are periods where investors are not getting higher return despite taking more risk, they should not feel so worried. Just remember that the long term result will impose itself over time.

Taking more risk subjects one to a wider range of potential outcomes. In today's market environment, this is more applicable than ever.

Best regards,

Alvin Goh

Alvin Goh
Chief Investment Officer

[2] Global bonds: Bloomberg Barclays Global Aggregate Index Hedged, Global equities: MSCI ACWI Net Return USD Index

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