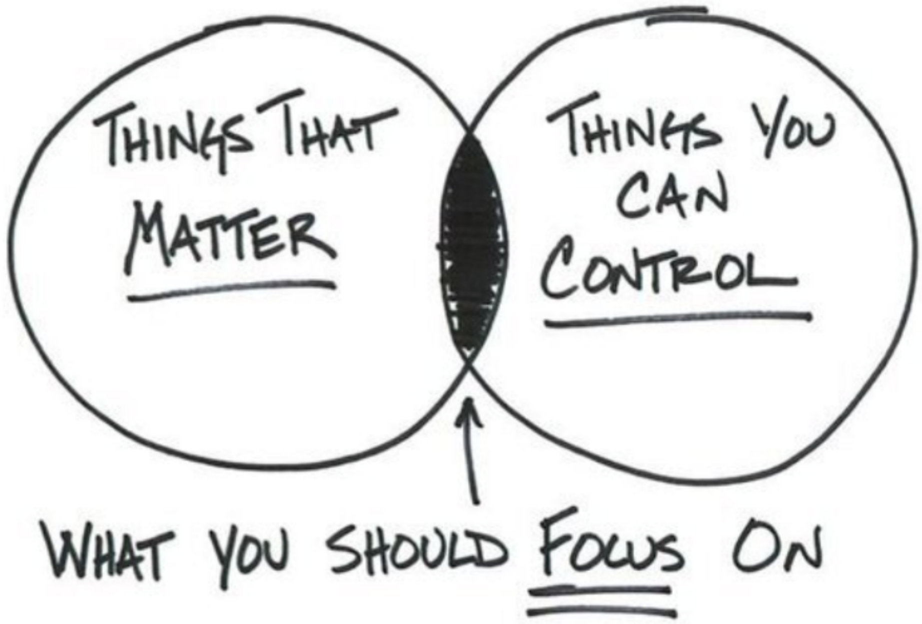
A Wider Definition of Margin of Safety



Source: https://twitter.com/tbonegallagher/status/470872846089338880

There is a lot of ink being spilled on COVID-19. Who saw it coming? Who didn't? Who are the heros? Who are the villains? How will it change the world? Etc. etc. etc.

I don't have a crystal ball to tell you what lies ahead but I can say that the five weeks from February 19th, 2020, to March 25th, 2020, were perhaps the most intense of my career. Suddenly, risk was everywhere. The range of possible outcomes was a mile wide, and most looked pretty bad. The S&P 500 and MSCI AC World indices both fell ~34%, the sharpest bear market in at least fifty years. Owning a portfolio of businesses across geographies and industries offered virtually no diversification. And while it's too early to say if the investment decisions I made during those weeks were right or wrong, it's not too early to recognise the stress I was under. I don't think you'll hear many other investors acknowledge this because it won't fit with the image they project of omniscient, stoic supermen.

Difficult experiences can be valuable if we learn from them, though we can only learn from them if we're honest with ourselves. Anticipating the next once-a-century global pandemic is fighting the last war. It's not helpful to play Monday morning quarterback either and speculate on the "what ifs" or the "if onlys". But there is much to gain from exploring the sources of the stress I experienced because they are likely to manifest themselves many, many more times during my career. From this, I've thought about how to manage stress better and build a more resilient investment practice - *a wider definition of 'margin of safety', if you will*.

<u>What created stress?</u>

I'd like to think I'm used to handling the ups and downs of the market and of my own portfolio. I won't claim to have ice in my viens but the businesses in which I invest are typically robust and allow me to look beyond the immediate future. But those five weeks were a tempest. In addition to my family's immediate health and safety, I can place the things which added to my stress into three broad categories:

First was the speed at which events unfolded. The dissonance between my mental model and what was actually happening widened *exponentially* every day. I won't go into too much detail as it would be too specific - shoulda, woulda, coulda! Suffice it to say that my working assumption was that the situation would unfold like SARS did in 2003; that is, it would be limited to Greater China (and South Korea) thanks to swift action from governments and citizens. Moreover, in line with this working assumption, I focused my attention on the improving situation in China rather than the worsening situation in Iran and then Italy.

Second was the mental dilemma of holding myself to the principles of a business owner - that is, someone who purchases stakes in real businesses through the stock market to hold for a long time. This philosophy ordinarily disciplines my investment process and anchors me through market volatility (like I was saying above). It gives me a bias towards inaction because business owners stick with their companies through thick and thin; the ups and downs of share prices should not faze them. Do business owners trim positions they like to 'reduce portfolio risk'? Nah, I thought. Wouldn't that just be market-timing? But in this instance, didn't the range and negative skew of possible outcomes warrant exactly that? I was caught between these two poles.

Finally, there were emotional stresses. My mum listened to the drumbeat of cable news and became anxious that her retirement nest egg was evaporating. She grew up poor and was terrified of being left again without means. (My dad on the other hand was urging me from late February onwards to buy Carnival Corp lol). Then there was my girlfriend. She works in London, a long way from home, and lives alone in a basement flat. In the worst case, she could have been trapped there for months without care or support.

All this is to say that I was abnormally stressed and acting on the backfoot. I was predisposed to be fearful at perhaps just the time I should have been greedy.

What helped in the heat of the moment?

I'm going to make the case below that the best preparations for a financial panic begin years in advance. But I want to acknowledge too that some actions really did help in the heat of the moment. One of the first things I did was to read up on history to update my mental model. I drew a roadmap listing possible future events indicating the crisis was getting better or worse - things like governments declaring national health emergencies and instituting lock-downs; or central bank stimulus etc. This immediately made me realise that the most shocking headlines of the day were in fact steps towards the crisis' long-term resolution. In the same vein, there was a great interview with Michael Mauboussin released in March in which he suggested "simply doing the math": what do valuations look like if you 'X out' the next two years of earnings? All of these approachs helped to make sense out of chaos, and to supplant emotions with analysis.

Talking with friends was helpful too, both inside and outside the investing industry. Human contact – even a simple telephone call – felt great and reduced my sense of physical isolation. Our conversations allowed us to articulate our thoughts, and to find some signal in the noise. One of these calls helped me pivot at a critical moment.

We also brought my girlfriend back from London. She sought permission from her firm and despite their initial hesitations, she was home two days later.

Towards a wider margin of safety?

The point isn't whether or not I could have better foreseen the impact of COVID-19; it's that when the shock hit, I needed to be in a better mental position to withstand it and profit from it. How can I invert the situation to make it more likely I'm acting on the front foot in the future?

Analysts look for a margin of a safety in the individual companies they analyse. Portfolio managers look for a margin of safety in where they choose to invest, the prices they pay and the way in which they construct their portfolio. Business owners create a margin of safety by designing their companies with multiple points of redundancy.

An investor's margin of safety should not stop there.

Let's start from the basis that actually, none of us are omniscient and nor are we supermen. I know for a fact that I'm actually very biased and very fallible! I make mistakes, often! What this experience brought home is that I need to therefore arrange my life and practice with redundancies to allow for this. *I need to work and live with a margin of safety so that I can better manage life's surprises - and thrive on them.*

Here are some early thoughts on how:

- Never invest without a margin of safety. This sounds so obvious but it's worth repeating ad nauseam. Everyone will define their margin of safety differently because they will perceive risks differently. But you must know in your bones what risks you can accept and what you can't. Don't accept the former without adequate compensation. And do everything you can to avoid the latter. As Charlie Munger likes to say, "All I want to know is where I'm going to die so that I never go there".
- With this in mind, design an investment process that quickly filters out marginal ideas, be they outside your circle of competence, complex, fragile, expensive or speculative. Using strong filters to focus your time won't just maximise productivity; it will also steer you away from risk.
- Construct your portfolio so that you can sleep at night. I'm happy with 10-15 positions I know well. Everyone will be different here; there's no right or wrong answer. Buffett was highly concentrated; Peter Lynch had a thousand stocks - and both did well.
- Structure your business to be resilient. Rob Vinall wrote about this very well in his memo, "Some Thoughts on Becoming an Independent Fund Manager". His ideas include designing your fund structure right; avoiding conflicts of interest which pressure you to grow too fast; and keeping fixed costs low. Another of Rob's decisions was to be a "one captain ship". I see merit in this because it minimises commitment bias.
- Acknowledge the importance of your clients and work hard to earn their trust. I wrote about this earlier with respect to Richard Lawrence and Overlook where his firm emphasises transparency and commitment to a process ("the Maadel!"). I'd just add that it's important to recognise how volatility can matter to clients' emotional wellbeing. For this reason, it's important to encourage them to be well diversified in their own finances. Rob Vinall also recommends allowing your clients to self-select, even if this means growing your own business more slowly to

begin with. First State Stewart manages client expectations by telling them that while they will not outperform in a bull market but will make up for it in a bear market. This steers the conversation towards risks and encourages everyone to anchor on the long term.

- Organise your own life to build emotional resilience. Have enough cash in the bank for a rainy day. Keep a modest lifestyle. Nurture a good family life. Exercise and stay healthy. Build a support network. Have outside friends and hobbies. Don't spend every day staring at prices in the market or worrying about what the index has done!
- Be prepared to forego some gain to insure against risk. Recognise the option value of cash and liquidity, as well as the emotional cushion they provide when times are bad. How do I square this with my desire to invest like a business owner? Well, if my portfolio was a conglomerate, then a prudent business owner would run it with ample cash on the balance sheet.
- Perhaps re-balancing should be a routine action, as David Swensen suggested in his book, "Pioneering Portfolio Management". A business owner investing through financial markets would happily take advantage of Mr. Market when he is too optimistic. Doing so also gives you another emotional cushion to add back to a position when it is down. Buffett is not a good teacher in this respect as he has the luxury not to trim positions because they are diluted every day by the fresh cash sent to Omaha by Berkshire's insurance operations. He and I are running qualitatively different investment practices.
- Don't be constrained by old mental models. If I may quote Munger again, "We work hard every year to tear down our existing assumptions". Likewise, a friend described to me George Soros' advice to 'clear the decks' whenever he no longer understood markets. Liquidating his portfolio gave Soros the mental space to reflect without pressure and endowment bias. Even if one can't do this in practice, it's probably still a helpful exercise to reconstruct your portfolio from scratch from time to time to create some emotional distance.
- Welcome every day as a new day to act. *A bias towards inaction must not mean a bias towards no action.*

None of these steps begin during a crisis. They are habits and structures which must be ingrained beforehand - many years before, in fact. They are lifestyle and business choices, not a first aid kit. Bill Miller would call this building a behavioural advantage.

Perhaps you've seen the Venn Diagram at the top of this post before. I like it because it reminds me to focus action and mental energy where it can count.

It also reminds me not to be fatalistic; I can choose to be in control over some things that matter greatly - *not everything but perhaps just enough to make a difference*.