RETURN AND RISK

When 2023 ends in a few months' time, it will be 15 years since we switched to our current investment strategy for the Fund. While in reality that is almost 5,500 days of waking up and falling asleep thinking about our investments, looking back it seems like a blink of an eye. The oft-repeated saying about how fast time flies is unfortunately one of those inexorable truths.

Vltava Fund's overall return across this period is 420%, which is approximately 11.8% per annum. The MSCI World Index, which is the logical benchmark for a global equity fund such as Vltava Fund, has increased by 232% over the same period (approximately 8.5% per annum). You know these numbers from our regular monthly Fact Sheets and it is almost unnecessary to repeat them here. I mention them only as an introduction to the topic I want to address today, which is risk.

When people talk about investing, the question of returns is very typically the central focus. They discuss the returns of individual stocks, indices, portfolios, returns over various past time intervals as well as expected returns in the future. I have written about this before, but, interestingly, in all my practice of over 30 years, I never have been asked the question, "How much risk do you have in your portfolio?" It is as if no one cares about risk. Yet return and risk are two sides of the same coin, they cannot be separated, and without an idea as to the level of risk one cannot even evaluate returns. To some extent this failure to pose that crucial question is understandable, because, while return can be well and objectively measured, and everyone can imagine what a return of, say, 50% means, risk is more problematic. There are three reasons in particular: First, there is no objective definition of risk. Second, risk is not precisely measurable. And third, this is a largely subjective category. What seems too risky to one person may seem quite alright to another, and vice versa.

One often hears the (sometimes mindlessly repeated) argument that to achieve higher returns, one must take on greater risk. In the world of such thinking, the explanation for our 15-year outperformance of the stock market index would seem to be that it was achieved at the cost of taking excessive risk. In fact, the exact opposite is true. The risk of our portfolio is much less than the average risk of the stock markets. Now you may be thinking, can a narrowly concentrated portfolio like that of Vltava Fund's be less risky than a broadly diversified market portfolio? Yes, it can, and I will undertake to explain why.

What risk is and is not

What is investment risk? How can it be defined? Well, let us start with what risk definitely is not. Risk is not equal to volatility. Standard financial theory often defines risk as the price volatility for a given asset. The more volatile its price has been in the past, the more risk that is attributed to the asset. Unfortunately, this approach to risk is completely mistaken. The historical volatility of an asset's price tells you only one thing – how much the price has fluctuated. It tells you nothing about what the investment risk of the asset has been, what its future investment risk will be, or even what its future volatility will be. So why is risk often measured in this way? With just a little dose of cynicism, I would say it is because volatility can be measured and, in doing so, elegant mathematics are used that most people do not understand, thereby giving those who make such reckonings an aura of academic sophistication.

But when you look not at what academic theorists but investment legends like Warren Buffett, Charlie Munger, Benjamin Graham, Seth Klarman, Francois Rochon, Nick Sleep, and others have to say about understanding risk as volatility, you find yourself in a completely different mindset. That way of thinking regards ill-considered investments as the main source of risk, and it welcomes volatility as a source of opportunity.

I will try to show the fundamental difference in this style of thinking by the following simplified example. Suppose your investment objective is to beat inflation over the long term. This is a perfectly realistic and reasonable goal in practice – to strive to increase the real value of your investments. What will be the source of risk for you in this case? The risk will be something that will threaten or even prevent you from achieving this goal. If you base your investments on holding cash, you will achieve the lowest possible volatility. According to standard financial theory, your portfolio will therefore have minimal risk. In practice, however, this will ensure that you will never achieve your investment goal of real appreciation, because the real value of money declines over time. Cash therefore represents the greatest risk in terms of the probability of achieving your investment goal. As Warren Buffett says, stocks are more volatile than cash or bonds, but they are safer in the long run.

So, if we leave volatility to the theorists, how do we define risk in practice? Above all, we must abandon the idea that risk can be reduced to a number. In my view, risk is not measurable – certainly not ex ante but not even ex post. Physics knows a number of quantities that can be measured. These include length, trajectory, time, speed, mass, temperature, force, pressure, work, power, energy, and so forth. But risk cannot in any case be thought about in this way. Risk takes many forms, falls into numerous categories, and has unclear boundaries. Moreover, as I said, risk always bears an element of subjectivity.

How we understand investment risk

We understand risk as a question of probabilities, and we try to tilt the probability of a good return in our direction by taking particular steps. We consider the following three elements of risk to be key: awareness as to the limits of our own abilities and skills, avoiding the risk of permanent loss, and emphasising price.

If I had to name one occasion in which people most often lose money in investing, it is when they get into things they do not understand. I would say this is true for all types of investments and for all investors, regardless of their experience. We try to avoid this risk as much as possible by being very careful about where the boundaries are of what we (seemingly) understand and what we (almost certainly) do not understand. We then concentrate our investments only in areas that lie within this imagined circle of competence. Although we are gradually trying to expand our knowledge, we critically concede that there are many things that are still beyond our grasp. Our investing is based on exploiting the differences between the price and value of individual stocks. It is quite challenging to estimate with a reasonable degree of applicability the value of a company whose business we understand. It would then be quite absurd to think that it is possible to do so for companies that we do not understand. Keeping within the boundaries of our circle of competence is the most important element of risk management in our investing.

The second pillar of our risk management is to avoid the risk of permanent loss of capital. Or, better said, to minimise its probability. A permanent loss of capital is a situation in which an investor loses part (or even all) of invested capital on a particular investment without being able to recover it. We do not need to go far to find examples of permanent loss of capital. This spring there was a minor banking crisis in the US during which several banks failed. Two of the best known of these were Silicon Valley Bank and First Republic Bank. Both banks went into receivership and investors lost all their money. This capital is therefore gone forever, with no possibility of recovering it.

Permanent loss of capital is not the same as volatility. Share prices normally fluctuate. A difference of 40% between the highest and lowest price of a given share during the year is not unusual. For the long-term investor, however, volatility is not a source of risk. The source of risk is the permanent loss of capital. How do we try to avoid it? We know from experience that the most common causes of permanent loss of capital tend to be poor quality businesses, high levels of debt, and poor management actions. It is often the case, too, that these three causes occur together. Therefore, even with regard to companies we understand, we try to focus our investments primarily on those that have high returns on capital and strong free cash flow (a sign of quality), have minimal, often no debt, and have management that allocates capital efficiently and does not make big mistakes such as overpriced acquisitions or investments with low rates of return. Looking back over the past 15 years, I can find several instances of retrospectively very successful investments that we did not make because it would have required too much risk at the time of decision making. At the same time, however, we have not made a single one among the hundred or so investments that I could describe as a source of permanent loss of capital. We have set our risk limits quite low, and I think (altogether subjectively) that this is a good thing.

The last essential element of risk management is the emphasis on good price. It is quite obvious that the same stock will present a different level of risk at prices of $20, $200 or $2,000 (or in other currencies). Indeed, price is always a key element of risk. For each investment, we try to ensure that the price of the shares we buy is significantly below their value. Risk management here consists of three parts. First, we only try to estimate value for those companies where we can do so with an acceptable degree of confidence. We avoid stocks where this cannot be done, as this would be pure speculation. Second, we try to make the actual value estimates conservatively and realistically. Thirdly, the margin of safety between price and value really has to be quite thick. In practice, it is this last condition that often ensures to a large extent that even if we make a mistake in our judgement about the value of a company and its development, the investment can still be profitable.

The individual steps of our risk management approach are not measurable, some of them are even difficult to estimate, but all of them together are designed to eliminate the important risk elements present and thus over time tilt the probability of a good return in our favour. The result, or so we hope, is a portfolio that is far less risky than the overall market portfolio. We think we know quite a lot about the companies we invest in. By contrast, an investor who buys a broad market portfolio of hundreds or thousands of companies has to accept that he or she knows nothing about the vast majority of them. Our approach presents lower risk. The companies we own, taken as a whole, are of a higher quality than the market average. They have higher returns on equity and higher returns on capital. They have incomparably less debt than the market average. Some of them even have no debt at all. This makes them more resilient and less dependent on external financing. In our view, their managements have the important ability to allocate capital efficiently in addition to the ability to manage the business itself. This is a rare but very important skill upon which we place great emphasis. It has a major impact on creating the long-term value of a company. A large part of our portfolio is made up of companies that are controlled either by their founders or by a key shareholder for whom these assets are personally absolutely critical. This makes it more likely that the interests and motivations of the company's management coincide with those of the shareholders, and much more so than is typical for an average company in the market.

Last but by no means least, the Vltava Fund portfolio then trades at incomparably lower earnings multiples (currently at PE of 9) than do the broad markets, even despite the fact that it is composed predominantly of growth companies. As you can see, it is paradoxically lower risk that can provide the path to a return higher than that of the overall market. The definition of risk truly remains the alpha and omega.

When I think about what the next 15 years may bring, the following thoughts come to mind. There is no telling whether the Vltava Fund's portfolio return will be higher or lower than in the past 15 years. We hope that it will continue to be significantly better than the return of the markets because we know of a number of things we could have done better over the past 15 years. If we divide the past 15 years into four unequal multi-year periods, then the returns in each of those periods, as they have gone along, could be described as excellent, good, poor, and very good. This is probably a good indicator of what to expect in future. There will be periods very pleasant in terms of returns and other periods that will be disappointing. What you can count on, though, is that we will continue to regard risk as a very important aspect of our investing and that we are not in any way going to change our conservative approach.

Changes in the portfolio

We sold shares of Fortrea Holdings and Willis Towers. Fortrea is a new company formed by spinning off part of LabCorp into a separate entity. As of 1 July, LabCorp shareholders received one share of Fortrea for each LabCorp share as part of this spinoff. We did not like the independent Fortrea because at the beginning of its stand-alone existence it was burdened with a relatively large debt, which is costly and significantly limits management's options for dealing with generated profits. Therefore, we sold the shares almost immediately after they began trading independently and used the money to increase our position in Stellantis stock. Our joy could not have been greater as soon afterwards Stellantis announced unexpectedly good half-year results while Fortrea shares were moving to ever lower new lows.

We sold the Willis Towers shares after holding them for about 2 years, with a return of only about 10% (which is nevertheless slightly greater than that of the US market over the same period). Our initial perceptions as to the quality of this business were more positive than what has gradually become apparent in reality, and these shares seemed unattractive vis-à-vis other opportunities presented to us.

A new position in the portfolio is the US health insurer Elevance Health. This sector is quite familiar to us. In fact, we also have shares of another health insurer, Humana, in our portfolio, which we first bought in 2009. The sector has been very attractive over the long term and its structure favours big players, which both Humana and Elevance Health are. Because each of these two companies also has some specific risk, we decided to increase our investment in the sector by acquiring this second position. Both companies are high-growth in terms of profitability and we expect their above-average growth to continue for quite some time. Elevance Health benefits uniquely from its exclusive licence for the Blue Cross Blue Shield brand in 14 US states and is the largest US health insurer with revenues of $165 billion. It insures one-third of the population in the states within which it is active. This large market share gives Elevance Health two competitive advantages: lower costs and network effect. It is also worth noting that this is a non-cyclical business whose growth and development is only minimally correlated with the normal business cycle. It perhaps could go without saying that we consider the investment in Elevance Health to bear below-average risk.

Invitation to the conference

In November, together with Lenka Schánová, we are organising the 10th edition of the Czech Investment Conference. You are all cordially invited again! The programme and registration can be found here: www.czechinvestmentconference.cz

Daniel Gladiš, October 2023

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