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The Art of Investing: Creating Low Cost Hedges

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I often hear people say, "Oh, I do not want to take any risk" I then ask them to define "risk". In general, people answer: "I do not want to lose money." I then ask them if a fluctuation in value of their listed stocks means for them "losing money" during the downward sequence. The answer varies, but I would say that generally a drop that lasts more than three years will test the patience of the average investor; if this results in a sale of stocks at a loss, this would then clearly cause a permanent loss of capital. I then go on to discuss an often-overlooked risk, that of a major loss of purchasing power in retirement. The discussion then revolves around how to balance three different types of risks: loss of purchasing power in retirement, permanent loss of capital, and fear/impatience with volatility.

It is impossible to protect one's purchasing power, let alone build one's financial independence without exposing one's investments to some form of uncertainty. Absolute or near absolute safety has a huge cost in the long run for individual investors. It has its place for short holding periods, say five years or less, but the longer the investment horizon, the more difficult it is to justify. We must balance our risks according to our needs and our profile and for most of us, we must learn to live with uncertainty; this requires making a list of the risks to which we are exposed and taking steps to mitigate them.

Learning to live with uncertainty

I would like to say just a few words about two basic notions of risk management. We often hear: "do not put all your eggs in one basket". The notion of diversification deserves to be clarified because it is often misused in our industry by people who overdiversify to cover their lack of effort into researching their investments. No diversification, no matter how wide, can compensate for poor knowledge. It is better to limit oneself to investing in assets one has sufficiently researched. The deeper our knowledge, the less we need to diversify. Still, one must have the clear-sightedness and humility to judge one's own knowledge. We must each find our own balance, or comfort zone on the scale *Confidence in our knowledge / Concentration of our portfolio*.

Another aspect of diversification is the degree of correlation between the different assets in a portfolio. "Correlation" refers to assets whose value fluctuates in the same direction in response to the same factor. For example, cyclical firms will generally see their sales rise more strongly during a period of economic expansion and decline more sharply during a contraction of the economy. Two companies with the same degree of cyclicality will tend

to be "correlated", their sales, profits and often their stock market value could react to the business cycle in a similar way.

Portfolio diversification requires establishing of a set of weakly correlated assets, which will react differently or even in opposite direction under different economic environments or in the face of certain events. For example, some assets will benefit from higher interest rates while others will suffer. Same thing for a rise or a drop in inflation, or in the price of commodities. Hedging against different economic scenarios or against different events is good risk management practice.

An interesting example of portfolio construction is given by the Berkshire Hathaway conglomerate, which includes in its portfolio both residential insurers and construction and home building materials companies. When a hurricane hits, Berkshire loses on insurance but gains on construction.

Oaktree Capital's acquisition by Brookfield Asset Management

I never cease to be amazed by Brookfield's ability to seize opportunities at the right time. They recently announced a 62% equity stake in Oaktree Capital. The latter is an alternative investment firm specializing mainly in debt securities, particularly distressed debt. This type of investment thrives especially during financial crashes and economic crises and is therefore countercyclical. Oaktree has made large returns, especially during the 2000 and 2009 crashes. For several years, the environment has been less favorable for the distressed debt market. Oaktree’s stock price has basically stagnated since it started trading in April 2012.

A good portion of Brookfield's assets are procyclical, that is, they thrive when the economy is doing well. Combining procyclical assets and expertise with countercyclical assets and expertise is an astute risk management strategy.

But what is masterful in my opinion is to buy a stake in Oaktree now, after 10 years of globally positive market and economic cycle. Brookfield does not pretend to know when the next recession will occur nor its magnitude but must think that most likely, we are getting closer to one. Pairing two high level teams with complementary expertise is clever. This is in line with Brookfield's investment philosophy: buy only high-quality assets when trading at an adequate discount, with a view to long-term holding.

The key is not so much the hedge, as the price paid for that hedge

The idea of covering oneself against different contingencies is not particularly original; it is the implementation of this idea at the right time and at the right price that is the key to solid and sustainable returns. For example, hedging against inflation at a time when all would talk about the risks of accelerating inflation would not be very useful because the price of this hedge at that moment would be too high.

In some ways, investing is an artform, where one balances shadows and lights, touches of colors and shapes to create a harmonious visual impression. Brookfield offers us a remarkable canvas of the art of investing.