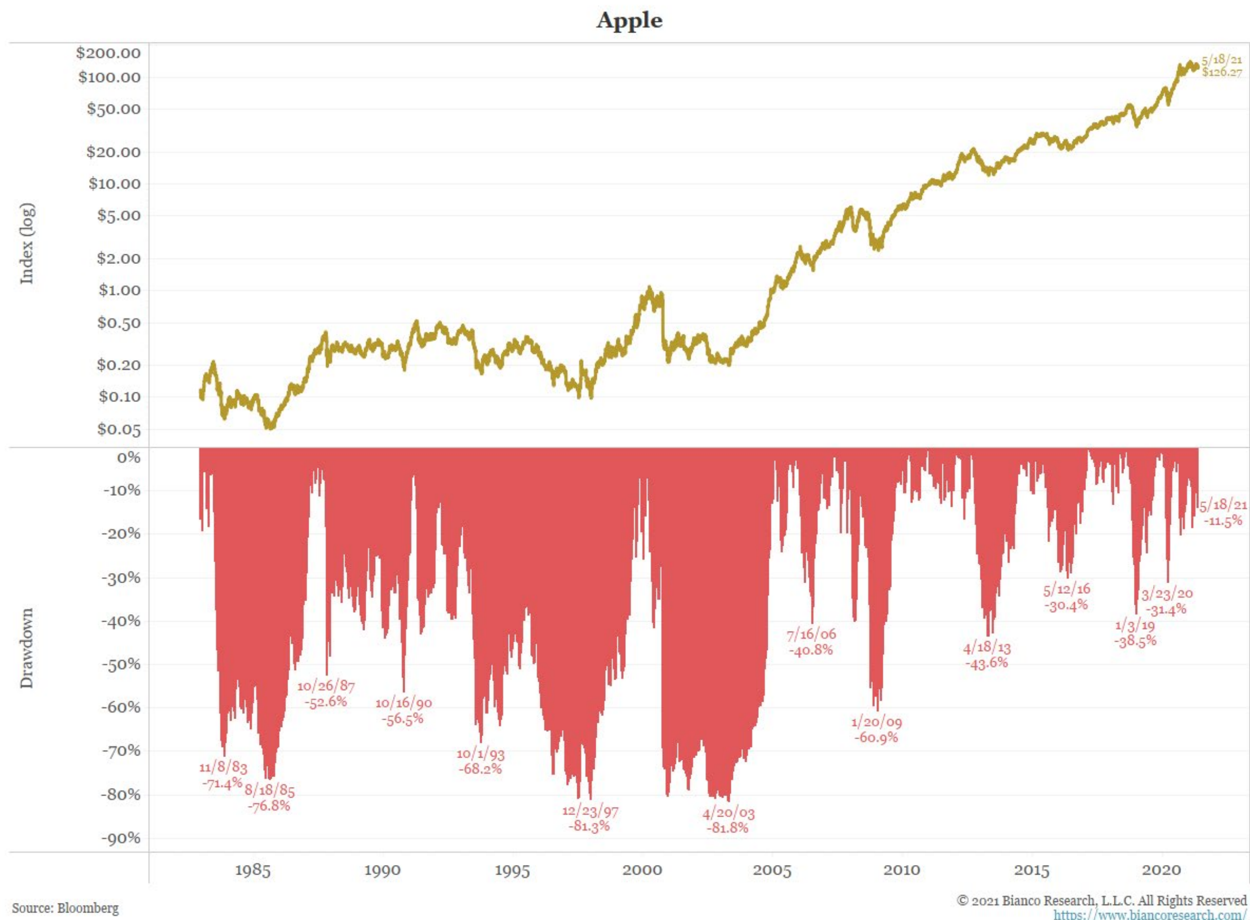
Back to Basics

If the novelist Leo Tolstoy had been an investment analyst, he may have observed: all happy investors are alike; each unhappy investor is unhappy in his or her own way. There is more than a kernel of truth to this spin of *Anna Karenina's* opening line (though it would make for a far less memorable read). Each happy investor is indistinguishable from the next; his or her portfolio has performed in alignment with their objectives and risk tolerance. On the other hand, all unhappy investors have a unique mismatch between what they own and what they are seeking to achieve.

Thoughtful portfolio construction is critical to long-term investment success, but that process is impossible without first defining one's own goals. Too often, investors get fixated on comparing their returns relative to "the market" or, even more toxic, their family and friends. To start, what is the market? Is it the S&P 500, the MSCI World Index, the Dow Jones, etc? If the S&P 500 – the index to which most U.S. investors compare their performance – 25% is comprised of just 5 stocks (Apple, Microsoft, Amazon, Alphabet and Facebook).[1] Thus, if you are underweight technology shares in a market environment where those are rising, which may be the case for investors seeking lower volatility and income, you likely will underperform. Yet, if you are otherwise achieving your objectives, your relative performance should be irrelevant.

The only benchmark that matters is the one you set for yourself. While we'd all probably like to think we're in markets to maximize our returns, few have the stomach to tolerate the type of risks and volatility that accompany aggressive growth investing. Be honest, would you have felt comfortable holding Apple over the last 35 years during the many instances it had extreme selloffs? For many, the peak to trough drawdowns (below, in red) would have been too much to handle.[2]



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KARMIN CAPITAL

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As we approach the middle of the year, we thought it might be helpful to return back to several critical investing basics that often don't get the consideration they deserve. When managing a portfolio, the first and most important step is figuring out what you are trying to manage for. Is it stability, growth, income, capital preservation, funding your living expenses, creating an inheritance for future generations? Some combination? The list is of possibilities is endless and different for each investor.

The second key step is determining how much risk and volatility you are willing to tolerate. As we have previously written, we think risk and volatility are distinct. Risk derives from uncertainty as to the fundamental outlook for a particular security. The more uncertain the outlook, the higher the risk (or chance of losing money), but the higher the potential for outsized returns if your analysis proves correct. Investors can manage risk through (1) diversification, (2) sensitivity to valuations when purchasing securities and (3) gaining a deep understanding of the underlying drivers of a particular company, industry or asset class. Volatility is simply the price variation of a security and may be related to risk, but is often driven by broader macro forces such as changes in interest rates, trading liquidity and investor sentiment to name a few.

Lastly, investors need to determine what time horizon is important for judging their performance. If you have a short horizon, your tolerance for risk and volatility will likely be much lower than for someone who has a decade's long outlook. For those with short horizons, we'd just caution that in a market increasingly driven by algorithmic trading, individual investors have limited, if any, short-term competitive trading advantage unless they know something that the market has yet to discount. While a long horizon may not be appropriate for everyone, the benefit is that patience provides time for a thesis to work out and for returns to compound. It also diminishes the impact of any short-term volatility, which even for the most vanilla of investments, is sometimes impossible to escape.

Everyone would love to own stocks and bonds that – in popular social media parlance "only go up" – but we all know that's just not realistic. In a diversified portfolio, one is bound to have a position that over some period underperforms their expectations. When this happens, there are three key questions to ask: (1) is the underperformance related to any fundamental changes or just a result of an asset class or industry temporarily falling out of favor, (2) why do you own that investment in the first place and (3) is the position's size commensurate with your confidence about the holding and risk tolerance? (As a side note: it's equally important to assess positions as they appreciate and to consider paring back if valuations become hard to justify or sizing relative to one's overall portfolio creates a concentration risk).

There are no free lunches unfortunately. If you seek growth, your holdings will likely be more susceptible to unpredictable declines; if you seek stability, your portfolio is unlikely to match the returns of growth companies during a bull market; and if you seek income, you are likely to experience volatility as interest rates change. Accordingly, for many investors, a balanced approach and diversification is the most psychologically tolerable portfolio construct and also results in the most consistent results. In the short-term the broader market environment is typically the largest driver of returns; but in the long term, being right about fundamental analysis is more important. That's why we generally favor a patient, research-driven and diversified approach.

Just like many things in life, if you master the basics of an activity you are more likely to achieve long-term success. Investing is unique in that the basics are different for each individual. Whatever your goal is, we are here to help you achieve it and are always happy to discuss whether your current portfolio composition is in alignment with your objectives.

Sincerely,

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Citations and Disclosures

[1] Bloomberg (as of May 20, 2021). All market data cited herein is from Bloomberg unless otherwise noted.
[2] Bianco Research (May 18, 2021).

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