Quarterly Letter

On preparation, complexity, and not being a hero

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Our office at New Court. The site has been home to the Rothschild family business in London since 1809.

Rothschild
Private Wealth

Foreword

A non-superstitious definition of luck is “success or failure apparently brought by chance, rather than through one’s own actions”. By contrast, skill is simply “the ability to do something well”.

When investing, it is important to know and acknowledge the difference between luck and skill. To invest well, you must concentrate on improving what you can control, rather than just hoping for – or complaining about – things that you can’t.

It’s possible to seem like a genius roughly 50% of the time – you buy something, and its price soon rises. The remaining 50% of the time you can seem like a fool – you buy something else; its price then falls.

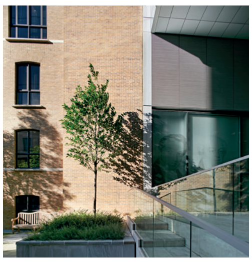
The mix of genius and fool will often depart from 50:50. In the short term, over days and weeks, this will be the realm of luck, mostly brought by chance, rather than the actions of the investor. Over the long term, however, it should be the realm of skill, and the result of things within an investor’s control.

On the following pages, we expand on this theme, drawing lessons from Antarctica in the early 20th century.

At a time when Britain’s decision to leave the EU is causing uncertainty, we hope this letter offers a welcome perspective.

Our focus remains on preserving and growing the real value of our clients’ wealth, for years and decades to come.

Helen Watson
CEO, UK Wealth Management



Cover: Photograph of our office at New Court.

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Rothschild Wealth Management
New Court
St. Swithin’s Lane
London
EC4N 8AL
+44 20 7280 5000

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"Victory awaits him who has everything in order – luck, people call it. Defeat is certain for him who has neglected to take the necessary precautions in time; this is called bad luck." Roald Amundsen

At first, an article linking polar exploration and managing investments may seem a little odd.

Pioneering explorers like Ernest Shackleton, Roald Amundsen and Robert Falcon Scott battled frostbite, hunger, scurvy and exhaustion. They worked on snow and ice, through blizzards, relying on dogs, ponies, sextants and skis. As investors, we work in comfortable offices, with stable air-conditioning, relying on annual reports, books, and desktop computers. Our greatest physical challenges? Stiff shoulders from a day sat at a desk, and jet lag following a research trip to the US or Asia.

Why then, given these stark differences, have we taken polar exploration as the backdrop for this letter?

Our answer is learning. If you care deeply about the work you do, you will always be seeking to get better at it. There will be no mental wall separating work from the rest of life. Naturally and organically, you will make connections, see parallels. Lessons from the weekend's reading help shape decisions throughout the week.

These lessons can come from anywhere, without necessarily being stretched or contrived. The source could be the arts or sciences, history or sport. In this case, it is Roald Amundsen, the Norwegian explorer who led the first expedition to successfully reach the South Pole, arriving in December 1911.

In this Quarterly Letter, we draw out four applications for investing.

For investors, it is important to be clear on what can be controlled – and to accept and prepare for the things that can't.

1. Focus on what you can control

Amundsen could control his own preparation, decisions and actions. He could not control the weather, or his competition (Scott's rival expedition to the Pole).

In the areas he could influence, Amundsen strove for mastery. He designed his own goggles, skis and the harnesses for sledge dogs. During the long winter before the march to the Pole, he expected his team to work regular hours six days a week, refining and adapting their equipment. This included shaving weight from sledges to improve performance, and remaking boots to achieve the best fit without chafing.

He experimented – including eating raw dolphin meat to see if it could be useful nutrition if shipwrecked. And he learnt from experts, including the Netsilik Inuit. From the Inuit he learnt survival skills, and adopted their use of animal skins as clothing, an improvement on the heavy woollen parkas favoured by Europeans, which perform poorly when wet.

Critically, he also built buffers and margins of safety as part of his preparation. "Every difficulty is foreseen, and precautions taken for meeting or avoiding it", Amundsen wrote in his account of the expedition. For example, rather than rely on just one flag to mark their supply depots, Amundsen's team used black empty food containers to provide a marker every mile, and six foot stone piles to mark their route every three miles. To provide further protection, for five miles either side of each depot, they laid lines of bamboo flags every half-mile.

For investors, it is important to be clear on what can be controlled – and to accept and prepare for the things that can't. For us, short-term price swings and market movements are the equivalent of the Antarctic weather. These are things we must take as they come.

Sometimes the weather will be favourable, helping us on our journey. Sometimes, it will be more like a blizzard, slowing us down or pushing us backwards. At all times, we need to be prepared.

To us, this means focusing on the downside and on what might go wrong, seeking margins of safety, challenging ourselves to uncover our blind spots. It also involves trying to understand how we can better cope – and perhaps even thrive – in extremes.

Aside from market movements, many aspects of investing are within our control, and we strive for mastery in the most important areas. This involves developing a thorough and in-depth understanding of our portfolios, their component parts, and how both the whole and the parts are likely to perform in different market conditions. It means, in our ongoing research, concentrating our time and energy on deepening our knowledge of the companies, funds and securities we already own (rather than flit between shiny new things).

It also means seeking to master emotions. On an earlier expedition, Amundsen spent nearly a year on a ship trapped by pack ice. The crew suffered from depression, insanity, near starvation, and scurvy. Amundsen remained calm, and used the experience to learn more about effective polar clothing and diets.

In investing, we believe temperament matters a great deal. An investment team may have first-rate intellects, excellent mathematical models, a clear philosophy and a robust process. But if they are unable to master emotions – say the temptation to panic sell in a crisis, or to join the crowd and buy high in a boom – they are unlikely to deliver good long-term results.

2. Avoid unnecessary complexity

To reach the Pole, Amundsen favoured simple tried-and-tested methods; Scott's rival expedition suffered from unnecessary complexity.

Scott had several different modes of transport, all varying in speed – ponies, dogs, motorised sledges, and man-hauling. He set out in November 1911 with 16 men, 10 ponies, 23 dogs, 13 sledges and 2 motor sledges. The motor sledges were a new and unproven technology. They were untested in Antarctica and soon broke down. The ponies were unsuited to the climate and all had to be killed, and Scott sent the dogs back to camp mid-way to the Pole. That left man-hauling – pulling 200 pound sledges through snow and ice, up and down a glacier and over crevasses, for more than 1,000 miles. In Amundsen's words, with man-hauling, "the men themselves have the doubtful pleasure of acting as ponies".

Amundsen used techniques he'd learned from the Inuit, techniques they had perfected over thousands of years. His logistics were simple: five men, plus dogs. Dogs were low maintenance, did the bulk of the hauling, and were much better suited to the cold than ponies, allowing Amundsen to set out two weeks earlier in the season than Scott.

In every area, Amundsen seems to have simplified well. His tents could be put up with one pole; Scott's required five. He used pre-prepared navigation sheets and relied on a light and simple sextant to determine his location; Scott used a theodolite, a heavier piece of equipment that requires more mental arithmetic, increasing the chance of errors.

The biggest contrast is in the outcomes. While head-to-head comparisons can be misleading, Amundsen would sometimes cover twice the daily distance of Scott, in roughly two-thirds of the travelling time (5 to 6 hour treks, compared with 9 or 10).

Amundsen reached the Pole five weeks before Scott. His team's journey was smooth and uneventful, and the day they reached the Pole "passed without any occurrence worth mentioning". Scott's final team of five all died on their return journey. His *Message to the Public* attributes the "cause of the disaster" to a "sudden advent of severe weather", soft snow, and an early loss of ponies.

Our aim here is not to appraise the records of Amundsen and Scott but rather to draw out an application for investing: avoiding unnecessary complexity can make you less vulnerable, and improve your chances of success.

At Rothschild Wealth Management, we apply this lesson in two ways. The first is by keeping our investment process as straightforward as possible. We start with a clear objective, to preserve and grow the real value of our clients' wealth. This involves outpacing inflation, achieving prudent growth and avoiding irrecoverable losses – all over the long term.

When considering an investment, it's best to be wary of anything highly complex, impenetrable or opaque.

“Never has a man achieved a goal so diametrically opposed to his wishes. The area around the North Pole – devil take it – had fascinated me since childhood. And now here I was at the South Pole. Could anything be more crazy?” Roald Amundsen

From our Global Investment Strategist and Heads of Portfolio Management to our specialist equity and fixed income analysts, our whole team is focused on creating and improving portfolios to meet our objective. The portfolios we build have just two parts and we take decisions collectively, as a small group of people who know and trust each other.

All that may sound obvious, but many investment houses see a complex process as a sign of sophistication. Teams often have multiple objectives, mixing absolute and relative returns, and portfolios can be split into eight or ten different parts. One committee may set the house strategic asset allocation before another committee adjusts that asset allocation tactically. Yet another group could then be responsible for populating the asset allocation with securities and funds, before another group brings it all together into a portfolio.

In our view, this kind of process is unnecessarily complex and has too many drawbacks to list here – from strange incentives to a lack of accountability. At its worst, the process seems designed to give just one message to clients: don’t try this at home!

Aside from process, the second way we seek to avoid unnecessary complexity is in the investments we buy. Our bias is to find the simplest way of achieving what we want to achieve. Say we are faced with a hypothetical choice between two equity investments. Both businesses have similar patterns of risks, and similar profiles of returns. Faced with equally attractive alternatives, we will tend to favour the less-complex option.

This does not mean all our investments will be simple – some areas of investing are necessarily complex. Nor does it mean we will always favour the simpler option – we will embrace a more complex alternative wherever we are convinced it is better.

To illustrate, consider some of the assets we currently hold to provide protection in a typical portfolio. These include options linked to the equity markets, a global macro fund, a fund focused on managing tail risks, and a fund of 20 to 25 different trend-following strategies. Wouldn’t government bonds in the US, UK or Europe be a simpler alternative? Yes, without doubt. But, in our view, most of these bonds are expensive and overvalued. As a result, we believe they are unlikely to provide the protection we seek. In the future, if bond prices and yields become more attractive, they may once again be compelling as a simpler alternative to some of the assets we currently hold. In the meantime, we are comfortable holding more complex investments.

3. Accept the cost of your priorities

As a leader, Amundsen was good at fixing objectives, making trade-offs, and living with the direct and opportunity costs of the priorities he set.

Scott’s primary objective was to reach the Pole first. But his expedition also made important contributions to the scientific knowledge of the geology and biology of Antarctica, and provided evidence for the theory of continental drift. Even when one of his team was suffering from frostbite and exhaustion, Scott allowed a break to “geologise”, adding 30 pounds of fossil samples to their sledges.

By contrast, Amundsen described his plan as “one, one and again one alone – to reach the Pole”. He accepted that the cost of setting this priority was not contributing much to science. To meet his goal he was willing “to throw everything else aside”.

Consider also Amundsen’s ship, *Fram*. This was built for security, warmth and shelter. To withstand the challenges of ice, it was sheathed in the hardest South American timber available. The ship carried an “extraordinarily copious library” to keep the crew entertained during long voyages and bleak winters. Again, these priorities came with costs: *Fram* was slow on the open seas, and rolled uncomfortably.

In our approach to investing, we seek to be clear and open about the cost of our priorities, and our portfolios perhaps share a few traits with *Fram*. They’re built for security and shelter – designed to withstand bleak winters – rather than for pure speed. While we don’t want to roll uncomfortably, our performance will often come in bursts. Weeks or months of rapid progress may be followed by times of drift in the doldrums. This makes us different from most other wealth managers and from common benchmarks: they are vessels built for different seas.

Within our portfolios, the priorities we set also have costs.

On one side of our portfolios are our return assets. These are mostly shares in individual companies and specialist equity-related funds. Their priority? To grow in value and generate strong returns over the long haul. The related cost? Having individual holdings in a portfolio that will be volatile. Sometimes, individual return assets will fall heavily in price. And, when stock markets fall, the price of our return assets tends to fall too.

On the other side of our portfolios sit our diversifying assets. Their job is to perform well during a sustained downturn in equity markets, and at times when markets are volatile. This priority also comes with a cost: our diversifying assets will sometimes be a drag on performance. At times when stock markets are rising strongly, our diversifying assets will usually weigh on returns.

Fortunately, portfolio construction is not a zero-sum game. By combining return and diversifying assets in the way that we do, we compensate for weaknesses, rather than neutralise strengths. This is why we encourage clients to focus on the performance of their overall portfolio: the diversified whole is designed to be more stable than the component parts. It is the overall portfolio, rather than the individual return and diversifying assets in isolation, that aims to beat inflation, avoid large losses, and deliver good growth over the long term.

4. No heroes, please

The era of polar exploration in the late nineteenth and early twentieth centuries is known as The Heroic Age. The emphasis was on great triumphs, conquering new territory, breaking records. Leaders were praised for their “indomitable will and boundless courage” (to quote Amundsen on Shackelton) and for victories of “the human mind and strength over the dominion and powers of Nature” (to quote Fridtjof Nansen on Amundsen).

In seeking the glory of reaching the Pole first, Amundsen was prepared to get there “at any cost”. As with many heroes, the quest for greatness continued long after a defining triumph. And the quest came at a high price: Amundsen was declared bankrupt in 1924 and died in 1928 in a plane crash in the Arctic.

Here, we draw a contrast with what we believe to be healthy investing.

“For scientific leadership, give me Scott; for swift and efficient travel, Amundsen; but when you are in a hopeless situation, when there seems to be no way out, get on your knees and pray for Shackleton.” Sir Raymond Priestley

In investing, there are great individuals and teams, people who deserve recognition for their achievements. There are heroes, of a sort, and our heroes have both inspired us and helped shape the way we approach our work. Yet, unlike the polar explorers, we don’t think investors should be striving for greatness.

A death or glory mindset can be disastrous in investing. Second place is not the first loser. And there should be no fear of missing out.

When managing money, we believe the first objective should always be good stewardship of a client’s wealth. Acclaim or hero status should never become the goal.

Conclusion

Focusing on what you can control, avoiding unnecessary complexity, and accepting the cost of priorities are all valuable lessons we can learn from Roald Amundsen and his achievements in the Antarctic.

In drawing the parallels here, we hope to have offered a fresh perspective – on our investment approach, and on the factors we believe will help us deliver long-term investment success for our clients.

Notes

At Rothschild Private Wealth we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation-first is the right approach to managing wealth.