Seed Weekly

Investing in Times of Uncertainty

seed investments

Let's face it – it sure feels that there is greater uncertainty in our day-to-day life now, more so than ever before. But despite the uncertainty that Covid has introduced, the truth is that life is no more uncertain today than it was in pre Covid times.

This is relevant when thinking about investing, which can be thought of as the sum of all capital allocation decisions, made under conditions of uncertainty.

Because investing involves the future, and by definition the future is unknowable, there is ALWAYS an inherent degree of risk when investing.

The typical investor will attempt to use past return series, statistics, and data fitting into normal distribution bell curves, assuming that there is some equilibrium point. But because risk cannot be so neatly quantified, this is not only easier said than done, but actually of very limited value.

When successful investors figure what Carl Richards was quoted as saying, "*Risk is what's left when you think you've thought of everything*", they tend to focus less on trying to measure the impossible and more on constructing processes to deal with the inevitable uncertainty.

Some of the methods used may include:

- Probability analysis
- Matrix of mental models
- Thinking in terms of resilience and optionality
- Diversification

Successful investors learn to think and make decisions not in binary terms, but in **probabilities**. Decision making using probabilities is trying to estimate, using maths and logic, a range of possible outcomes ahead of time. This process *"forces"* an investor to think less about the desired outcome (i.e. in linear terms), and more about the range of possible outcomes and their consequences.

Charlie Munger, closest partner and right-hand man to Warren Buffett, uses the concept of **mental models** to understand the world, simplify complexity, and in so doing improve learning and decision making. Typically, investors benefit when they can move away from too focused or specialist a viewpoint and approach problems using a more multi-disciplinary mindset.

Uncertainty calls for constructing a portfolio with the concepts of **resilience and optionality** in mind as espoused by NZS Capital and others. Because there is no consistent way to anticipate the extreme outlier events (i.e. **risks to both the downside and upside)**, which come with a greater degree of regularity than a normal distribution would suggest, successful investors consider constructing a portfolio that has elements that are extremely resilient, combined with elements that have optionality.

Resilience, Optionality and Diversification

Resilience can be viewed in a number of ways, but encapsulates the idea of robustness (i.e. ability to withstand shock and optimise for downside protection). In a portfolio context it also "*buys you budget for optionality*".

Optionality on the other hand is at the other extreme – seeking out an asymmetric payoff profile (i.e. a large payoff from a relatively small investment), such that if it does not produce the upside, the downside will be limited. When understanding that risk or uncertainty also includes missing out on the upside, including elements of optionality into a portfolio becomes very valuable.

Diversification is a principle that we have discussed on many occasions and one that is generally well understood. As a basic portfolio risk management tool, it lowers portfolio risk and correlates with some of the principles discussed above. But simplistic overdiversification can have a detrimental impact to the overall portfolio by reducing performance to the market return but at higher cost. The big idea with diversification is to blend assets with low or negative correlations.

Conclusion

Successful investors tend to have an expectation that risk is always prevalent, even though they may not be able to predict the timing, nature, or origin of that risk. To mitigate against downside risk, they tend to build in redundancy. For risk of losing out on the upside it would be important to not only imagine what might occur, but to also incorporate this optionality into a diversified portfolio.

Kind regards,

Ian de Lange *(CA)SA*
Director & Chief Investment Officer

DISCLAIMER

Seed Investment Consultants is an Authorised Financial Services Provider in terms of the Financial Advisory and Intermediary Services Act (Act No. 37 of 2002). The laws of the Republic of South Africa shall govern any claim relating to or arising from the contents of this document. This document may not be amended, reproduced, distributed or published without the prior consent of Seed Investment Consultants.

No guarantee is provided as to the values of any financial product mentioned in this document. All illustrations, forecasts, information and opinions provided within this document are of a general nature and are not intended to address the circumstances of any particular individual or entity. This document does not constitute a solicitation, invitation or investment recommendation. While we endeavour to provide accurate and timely information, all illustrations, forecasts or hypothetical data are not guaranteed and are provided for illustrative purposes only. We make no representation or warranty, expressed or implied with respect to the correctness, accuracy or completeness of the illustrations, forecasts, information or opinions. No party should act upon such information or opinion without obtaining the appropriate professional and specialised financial, legal and tax advice based upon a thorough examination of their particular situation. Seed Investment Consultants will not be held liable for any direct or consequential loss or damage suffered by any party as a result of that party acting on or failing to act on the basis of information or opinion provided by or omitted from this document.

The value of financial products can increase as well as decrease over time depending on the value of the underlying securities and market conditions. Changes in exchange rates may have an adverse effect on the value price or income of any product.

Past performance is not necessarily a guide to future performance. Performance has been calculated using net NAV to NAV numbers with income reinvested. The performance for each period shown reflects the return for investors who have been fully invested for that period. Individual investor performance may differ as a result of initial fees, the actual investment date, the date of reinvestments and dividend withholding tax. Full performance calculations are available from the manager upon request.

Prescient Management Company (RF) (Pty) Ltd are registered and approved under the Collective Investment Schemes Control Act (No.45 of 2002). Collective Investment Schemes in Securities (CIS) should be considered as medium to long-term investments. There is no guarantee in respect of capital or returns in a portfolio. CIS's are traded at the ruling price and can engage in scrip lending and borrowing. The CIS may borrow up to 10% of the market value of the portfolio to bridge insufficient liquidity. A CIS may be closed to new investors in order for it to be managed more efficiently in accordance with its mandate. CIS prices are calculated on a net asset basis, which is the total value of all the assets in the portfolio including any income accruals and less any permissible deductions (brokerage, STT, VAT, auditor's fees, bank charges, trustee and custodian fees and the annual management fee) from the portfolio divided by the number of participatory interests (units) in issue. Forward pricing is used. In the event that specific CIS in securities are mentioned please refer to the relevant Minimum Disclosure Document in order to obtain all the necessary information in regard to that unit trust. In rare instances redemption transactions may be subject to a redemption fee. The applicable Prospectus and Key Investor Information Document will be made available upon request.

Please note that there are stipulated cut-off times for all documents, notifications of deposit, investment, redemption and switch applications. These cut-off times are product or fund specific and the applicable guidelines have been stipulated on the relevant supporting or transaction documents, application forms and Minimum Disclosure Documents. Where all required and supporting documentation is not received before the stated cut off time no service provider shall not be obliged to transact at the net asset value price as agreed to. Prices are published daily and are available on the Prescient website at www.prescient.co.za.

Investors should at all times remain aware of the risks involved in the buying or selling of any financial product. Where foreign securities are included in a portfolio there may be potential constraints on liquidity and the repatriation of funds, macroeconomic risks, political risks, foreign exchange risks, tax risks, settlement risks, and potential limitations on the availability of market information. The investor hereby acknowledges the inherent risk associated with any selected investments and that there are no guarantees (Paragraph 6(2)(f) of BN92). The Manager retains full legal responsibility for any third-party named portfolio (Paragraph 6(1)(g) of BN92).

For any additional information please visit our website on **www.seedinvestments.co.za.**