Consider this

M&G Investments

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April 2023

Respecting risk

Key take-aways

- An individual's tolerance for error can be guided by the amount of skill required to perform an activity and the severity of the consequences of getting it wrong. The more severe the consequences, the more skill required to perform it and the riskier the activity is considered.
- Any undertaking that takes a long time to know the outcome, like investing or certain health treatments, is risky because anything can happen in the intervening time.
- Skill and past success do not guarantee future success, some element of luck is also involved. One must therefore have an understanding of, and healthy respect for, the known and unknown risks and prepare for these. This is paramount in successful investing for the long term.

"Slevin: I have Ataraxia.
Lindsey: Ataraxia?
Slevin: It's a condition characterised by freedom from worry or any other pre-occupation really."

From the film *Lucky Number Slevin (2006)*

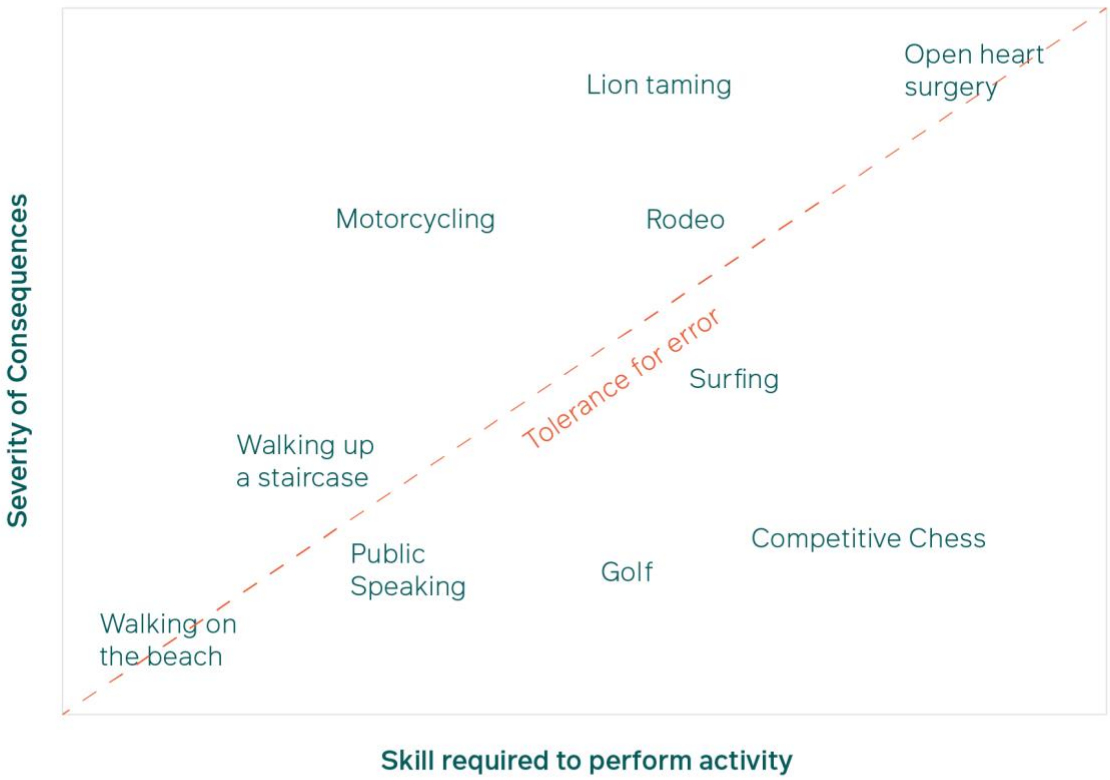
When was the last time you did something novel, and I mean really novel, like trying to perform open heart surgery? If you're not a cardiac surgeon, I'm willing to bet it's been quite some time since you've last found yourself clutching a scalpel targeting the point of incision over a patient's sternum. In fact, I am prepared to wager that you have *never* willingly opted to undertake such an experiment (once again, unless you are or have previously been a medical professional).

When we think about doing something unfamiliar, something new, we instinctively have a healthy respect for the potential risks involved. Something too novel, too complex, or too foreign, and our "spidey sense" kicks in, forcing a reconsideration. This sense of concern about the potential for things to go wrong is normal, so normal in fact that people who do not demonstrate it are diagnosed with a medical condition known as Ataraxia.

Our intuition serves us well in evaluating risks in novel activities. Although not a conscious effort, we're probably doing some unconscious algebra around variables like *"do I have the skill to perform this task"* and *"what are the consequences if I get it wrong"*. An activity is inherently risky when we require a developed skillset and the consequences of underperforming (or failing) are significant.

I'd imagine we have a map that looks a little something like this (Graph 1) in our heads.

Graph 1: Tolerance for error: Skill required vs Severity of consequences



Source: M&G Investments

We can think about these activities as running along a continuum of tolerance for error, represented in the graph by the diagonal line from bottom left to top right. Low-risk activities are those that are forgiving of error: those that do not demand a high degree of skill or impose significant consequence if something goes wrong. These are the activities we participate in during our leisure time or take up as hobbies. Conversely, if a task requires highly specialised skills and forces life-or-death consequences, it will often be regarded as risky to the untrained. The skills required to perform these activities safely need to be trained, and you're likely to see these pop up in competitive settings or even as a career (of the high-paying variety). Although we probably don't refer to it as such, I'm sure we have a sense for *tolerance for error* (the intersection of skill and consequence) and use it quite effectively when deciding how to spend our weekends. As a leisure activity, you want to know that errors will not result in severe consequence. Nevertheless, we enjoy the allure of danger, so long as the actual consequences are mild to non-existent. That's why more people are willing to try shark cage diving than they are lion taming.

The fullness of time

How do you know if you're good at something?

The short answer is feedback – in a game of tennis we know after we've won or lost the point whether the shot was good or not (setting luck aside for the moment). But what about when feedback cycles are lengthy, like deciding to make a career change? It is only in the fullness of time that the outcome becomes apparent and we can evaluate our decision. But even then, we cannot be sure that the decision was the correct one because longer feedback loops are prone to interference from outside factors.

I asked ChatGPT to provide a few examples of instances where longer feedback loops are prone to interference. Here's the output:

- Investments: Investment decisions can take years to yield returns, making it difficult to determine whether the decision was the right one. Factors such as market conditions, geopolitical events, and economic downturns can all influence the outcome.
- Education: The feedback loop in education can be quite long, with students only receiving grades and feedback after completing a course or an entire semester. By this time, it may be too late to make adjustments or improve their performance.
- Health: The feedback loop in health can also be lengthy, with the effects of certain lifestyle changes or treatments taking months or even years to manifest. External factors such as genetics, environmental conditions and unforeseen illnesses can also affect the outcome.

While I did not prompt ChatGPT to mention investing as an example of a long feedback cycle, it was unsurprising that it made the list. I was, however, not expecting health to be on it, and I think it provides an insightful element in long feedback cycles, namely the impact of unforeseen events.

Past success is no guarantee of future performance
"Despite his envy and admiration, he did not want to be Victor Niederhoffer. For when he looked around him, at the books and the tennis court and the folk art on the walls, and when he contemplated the countless millions that Niederhoffer had made over the years, he could not escape the thought that it might all have been the result of sheer, dumb luck."[1]

The excerpt above is from an article written by the famed author Malcom Gladwell published in the April 2002 issue of the *New Yorker*. The article follows from an interview with Nassim Nicholas Taleb, who at the time was on his way to becoming a famed author, but not quite there yet. The article provides an entertaining arc of the rise of the hero as he battles the ideals of the previous guard. Tactfully written, Gladwell weaves Taleb's central idea into the narrative, namely that unforeseen or random events can and do have the potential to change everything (which Taleb famously termed "Black Swan" events). More descriptively, there are domains such as investing, where a single event has the potential to wipe out decades of accumulated profit and vice-versa. This is a tricky concept for people to grasp, especially if they haven't lived through an historically tumultuous period precipitated by an event. These events are rare, and they bend the arc of history such that the period following the event no longer resembles the period preceding it.

There can be little doubt that investing requires insight and skill, but it is not the same sort of insight and skill required to perform heart surgery or fly a jet. Investing is an endeavor with lengthy feedback cycles, and as we know, anything can happen. Nevertheless, knowing that the future is unknowable can help us prepare. I am aware this sounds paradoxical, but the point is not that you might decipher the unknowable, rather that you might work into your outlook the possibility that something unforeseeable can (and often does) happen. Act and invest accordingly. This is the equivalent of a healthy respect for risk when it comes to investing.

As for Taleb's reluctance to model his trading on that of Niederhoffer, Gladwell lays to rest the tension created by concluding as follows. Niederhoffer sold a large number of options, betting that the markets would be quiet, and they were, until out of nowhere two planes crashed into the World Trade Center. "I was exposed. It was nip and tuck" Niederhoffer shook his head, because there was no way to have anticipated September 11th. "That was a totally unexpected event." [2]

Respecting risk is paramount to successful investing, so much so it could be the most important thing when it comes to long-term performance. Whether you were simply lucky for a long time or unlucky at the end is not really relevant – risk just needs to be respected.

https://www.mandg.co.za/insights/articlesreleases/respecting-risk/

[1&2] "Blowing Up" by Malcolm Gladwell, April 22 & 29, 2002 issue of *The New Yorker*.