THE SCANNER

MULTI-ACT
Built by investors for investors

Mitigating portfolio risk with a bottom-up approach

Risk usually has one of two reactions – either fight or flight. However, in the world of investing, risk is perceived and dealt with in myriad ways, with investors often either underestimating or overestimating the impact of risk on their portfolios. More often than not, investors are unable to generate returns in line with the fund in which they invest. This has been showcased by Dalbar Study[1] globally as well as the Morningstar Study[2] in India. Thus, it is a phenomenon that is not restricted to India, but prevalent globally as well. Such idiosyncrasies in risk perception and response to risk can be attributed to the behavioural biases that humans tend to exhibit at different points in time. These could include having a myopic view and only looking at the recent good performance of the fund or exiting in response to enhanced volatility or significant drawdown. High volatility and more importantly volatility on the downside can shake out investors. Lower volatility and drawdowns would increase the probability of the investor to stay invested in the long run. The question remains, 'How do we optimally mitigate risk while maximising returns?'

There are three levels whereby we, as investment managers, try to manage risk in our portfolio construction process:

RESEARCH

Over the long term, we have observed that the risk of permanent loss of capital can be materially brought down by investing in quality businesses. To identify a quality business, we are focused on long term business performance across multiple cycles. Therefore, we would avoid turnaround companies. There has to be evidence of superior performance in terms of ROCE, cash flow generation, and growth across multiple business cycles and preferably low or no leverage. We ensure that the reported financials are clean and indicate no red flags with regards to corporate governance. There should also be an identifiable barrier to entry or competitive advantage which should allow the company to sustain superior performance. Thus, we create our universe of investable quality companies which would be our hunting ground while constructing a portfolio, thereby **eliminating one level of risk,** which involves **getting into a wrong company.**

VALUATION AND TIMING

Buying quality at astronomical valuation can also lead to drawdown or losses. Thus, maintaining valuation discipline is important. We evaluate reward vs risk, i.e., **what is the upside if we are right and what is the downside if we are wrong.** Reward should be far higher than the risk we are taking, meaning the payoffs have to be better than 1:1. The other aspect is timing. Since we are dealing with probabilities, we have dynamic position sizing which changes based on incremental information. Thus, if we have bought an initial weight on pure valuation parameter, the scale up of that weight would depend on the incremental direction of the business and whether our thesis is moving in the right direction. If incremental information is confirming our thesis, we would increase weight. This helps us avoid over commitment in ideas which might not be moving as per our original thesis.

1. https://www.nytimes.com/2019/07/26/your-money/stock-bond-investing.html
2. https://www.morningstar.in/posts/70371/why-you-dont-like-your-return-of-a-well-performing-fund.aspx

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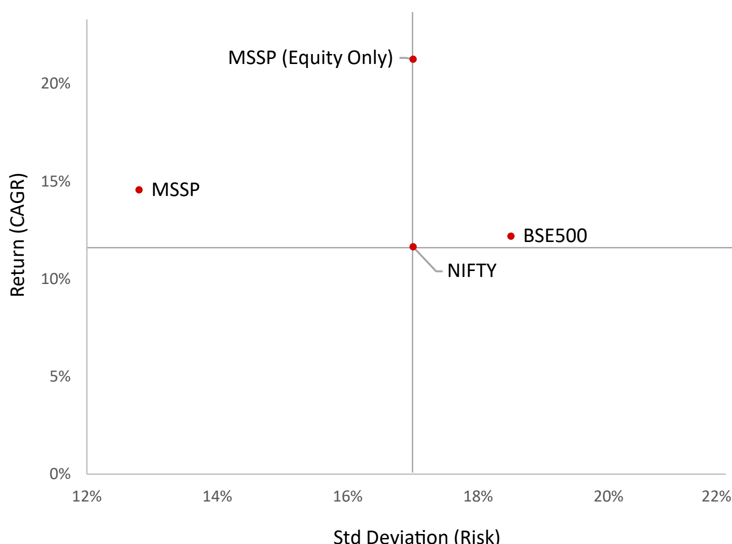
ASSET ALLOCATION/ CASH POSITION

Based on the bottom-up idea generation and the position sizing that we follow, we might not be able to deploy 100% of our corpus at any given time, thus holding cash in our portfolio. As stocks turn expensive, we also book profits. Thus, cash in our portfolio is a dynamic number which changes based on bottom-up opportunities and profit booking. In an exuberant market, our cash position would increase as we would book profits and might not have enough opportunities to add. Alternatively, in a weak market our cash position would go down, as we are able to find opportunities in our universe. This helps us to be **countercyclical and capitalise on market volatility.**

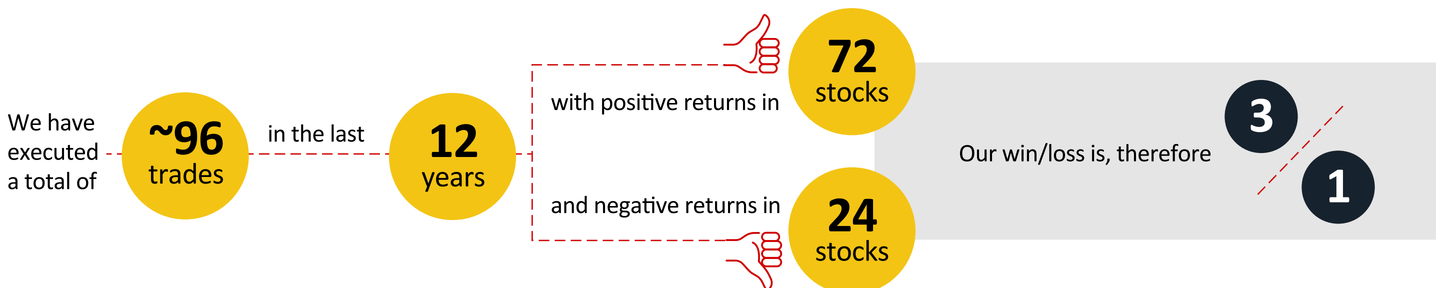
Spotlight: Moats & Special Situations Portfolio



Past Drawdowns	Reason for Volatility	MSSP	NIFTY	Benchmark
Nov-11 to Dec-11	Indian Economic Slowdown	-8.5%	-23.0%	-28.0%
May-13 to Aug-13	India CAD & Taper Tantrum	-12.1%	-15.0%	-22.0%
Aug 15 to Feb-16	China Slowdown Fear	-9.5%	-22.4%	-18.5%
Nov 16 to Dec-16	Demonetization	-7.1%	-11.7%	-13.5%
Jan-18 to Dec-19	ILFS Crisis	-9.6%	-14.4%	-18.5%
Jan-20 to Mar-20	COVID-19 Crisis*	-30.0%	-38.2%	-38.1%

**Disproportionate sell off. Our portfolio corrected in-line with the market but recovered at a faster pace compared to the market. It was back to the pre-COVID high by July'2020.*

We look at the Win/Loss ratio of our trades, or the number of trades where we have had a positive outcome vs number of trades where we had a loss. Then, within the positive trades, we consider the quantum of average returns vs the quantum of average loss in negative trades. The average return of winners in our portfolio is more than 30% CAGR while the average loss has been mitigated at 13%.



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Rohan Samant

Chief Investment Officer, Multi-Act

For a family office, what is risk while investing in equities?

While volatility is widely considered as risk, we feel drawdown and, more importantly, permanent loss of capital, is the true risk for a family office. That does not make volatility irrelevant. Volatility is inherent to investing in equities but if it forces the investor to exit equities at the wrong time, i.e., convert "mark to market losses" into permanent losses, then it should be treated as risk. So both volatility and drawdowns need to be monitored.

But in order to generate higher return, isn't higher risk required?

Taking risk is essential to generating return, but you are not "entitled" to higher return when the risk is higher. The common belief is that there is a positive correlation between risk and return, i.e., higher risk taking will lead to higher return. It is like you step on the accelerator, you know the car will move forward and the harder you press the accelerator, the faster the car will move. But in the investing world, where probabilities are involved, pressing the accelerator might have multiple outcomes, including the possibility of the car going backwards. As investors, we must be cognisant of the fact that we could end up at the wrong side of risk. We should know the downside if we go wrong and assess whether it is palatable.

Everyone talks about investing in quality stocks and buying below fair value. How is your strategy different?

Getting quality at a good valuation is not easy. There are 2 scenarios under which we add quality stocks to the portfolio:

- When the market goes through a crisis like the GFC, demonetisation, or Covid
- When a particular company goes through company specific crisis, like the Maruti Manesar plant closure or Nestle during the Maggi ban

These were periods when everyone was focused on risk with respect to the market or the specific stocks. The perception of risk was very high and thus, valuations were factoring the worst-case scenario while ignoring the probability of positive outcomes. The time horizon of the investor also changes the perception of risk. An investor/trader whose time horizon is restricted to a month or a year, might consider such events as risky. But when we buy into a business, we are looking to hold for at least 3 years. Thus, we are willing to go through near term pain as long as the business is good and is not structurally impaired. Accordingly, such events, wherein the perception of risk is high and the market ignores the probability of positive outcomes, is when we are willing to take a contrarian view. Historically, the highest returns have been made when the perception of risk was the highest.

Is there an opportunity cost in risk mitigation? Do you need to sacrifice returns in order to create a low-risk portfolio?

Returns can't be looked at in isolation. They must be considered along with the risk being taken to generate that return and we must appreciate the fact that the outcome that we are looking at is only one of the multiple possible outcomes. As investors, we should also consider whether we are comfortable with the negative outcome. For a family office it is even more important, when compared with an investor who has a smaller corpus. The true benefit of risk management would be visible only in times of crisis. Insurance will always seem like a wasteful expenditure until you are faced with the event that you were insuring against. As long as we maintain a favourable win/loss ratio at the stock level and ensure lower volatility and drawdown at the portfolio level, while performing better than the broader market in the long run, we believe we would have met our objective of generating favourable risk adjusted returns for our investors.

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