The question every investor should ask

By Adrian Saville

30 Jan 2019

Most investors' first question is, "How much money can I make?" But the accounting scandal at Steinhoff or business fraud at Theranos - and their subsequent share price collapses - highlight that an investor's first consideration should rather be,"How much money can I lose?"

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And risk extends well beyond the crass risk of accounting scandals and fraud: it can also take a veiled form, such as the “slow puncture” experience by industrial giant General Electric; it can flow from industrial shifts, seen in the cases of one-time champions Nokia, Xerox and Kodak; and risk can also flow from hubris, where AOL-Time Warner arguably stands out as one of the greatest failures in corporate finance in recent decades, which saw AOL’s value fall from $160bn to $4bn in the space of a few years.

Thus, while evaluating the likelihood of potential returns is a fundamental component of any investment decision, evidence suggests that considering the “upside” in any investment process only makes sense after we have examined and interrogated the “downside” potential.

And unfortunately, downside risk is far more prevalent than many realise. We only need to look back over the past few decades to see the investment landscape littered with defaults on debt instruments, the carcasses of defunct companies and the debris of failed mergers or acquisitions.

In fact, many studies have been devoted to analysing how many companies survive and thrive in the longer term. It turns out, it’s not that many.

Research

Research published in 2016 on the United States market shows that 80% of the companies that existed before 1980 are no longer around. Similar studies in South Africa published by Cannon Asset Managers have yielded comparable results. In the local case, we see this phenomenon in the changing composition of the Johannesburg Stock Exchange where only 20 companies that were in the top 100 in the mid-1990s are still in the top 100 today.

While companies fail for many reasons, we find that once they have become embroiled in a scandal or a governance lapse, this is usually followed by a call for greater regulation and better oversight from various regulatory bodies, based on the belief that if the market is more regulated, shareholders will be better protected.

This might be a rational thought, but it is not necessarily a sensible thought.

Governance

For example, auditors can offer increasingly tight guidance on governance, but this cannot be regarded as a guarantee on either governance or business performance. The investment world is replete with instances of firms that have failed despite the oversight of audit firms of global standing – just consider Lehman Brothers, WorldCom, General Motors, Chrysler and Enron.

Then look at the plight of fund manager Harry Markopolos, who flagged Bernie Madoff's Ponzi scheme years before its 2008 collapse. His first submission to the Securities and Exchange Commission (SEC) was in May 2000, which he followed up with several more detailed submissions in 2001, 2002 and 2005 – all of which failed to spark regulatory action as his whistle-blowing was not taken seriously.

Today there is more regulation than ever. Andy Haldane, Chief Economist at the Bank of England, summed it up when he pointed out that the banking industry's Basel rules grew from 30 pages in Basel I to 616 pages in Basel III in 2010. The 2016-2017 version of the Basel Accords (also called Basel IV) runs to thousands of pages. Yet, despite the ramping up of global banking regulations, the incidence of bank failure has increased.

Assessing risks

Three hundred years of capital market history further suggests that, as much as regulators try to find new mechanisms to protect investors, scandals, fraud and more "innocent" risk events (such as technological redundancy) are doomed to be repeated. Systemic risk is more pronounced now than it has ever been, which underlines the point that investing must start with risk management before it can turn its attention to reaching for returns.

In assessing risk, investors must start with macroeconomic risk and filter through industry risk, firm risk and all the way down to product risk, client risk and individual "key person" risk.

Risk is multifaceted and can stretch from the company level – such as the collapse of Steinhoff which hurt any portfolio that held the stock; the industry level – for example mobile phone businesses that were left behind, such as Nokia, Siemens Mobile and Motorola; and even at a currency level – a large, diversified portfolio of investments held in Zimbabwean dollar or Venezuelan bolívar would have had disastrous investment outcomes.

Finding the downside

If failure can happen in giant firms with skilled boards, experienced employees, deep pockets and with global auditors in place, it can happen anywhere. This puts risk management firmly in the hands of the investment manager (or investor), which means carefully and diligently assessing each investment for risks and vulnerabilities before considering potential returns.

This part of the investment process requires a wide-ranging, detailed examination of various business elements, such as the nature and extent of a company’s disclosures; the independence of its directors; executive and employee incentives; the rules and regulations that govern different fields of operation or geographies in which the firm operates; the ability of the firm to remain competitive in dynamic industries; the risks presented by customer or product concentration; and more.

In short, when assessing an investment’s prospects, there is no substitute for the hard – yet critical – work of understanding and assessing and establishing the “downside” before it is possible to find the “upside”.

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