

The Perspective

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The “Best” Returns *Part II*

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The “Best” Returns Part II

In previous editions of *The Perspective*¹, we have discussed the importance of recognizing risk and incorporating the notion of risk into your assessment of investment returns. In this issue, we thought it would be useful to highlight some examples – with numbers – of where it is crucial to risk-adjust returns in order to properly judge the results of an investment strategy.

¹ All previous writings can be found on our website, www.SilverHeights.com. We specifically refer you to “The Best Returns – Part I” from January 2008.



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Big Returns

What a difference a year makes! Last fall, investors were subjected to the beginnings of what would end up being a (hopefully) once-in-a-generation decline in the equity markets.

1-year chart for the TSX Composite Index
For the period ending Sept. 30, 2009



Source: MSN Money

However, as the chart above illustrates, the TSX index – like most markets around the world – has enjoyed a remarkable resurgence since the lows of March 2009. The index itself is up approximately 50% from its lowest point and 30% year-to-date through the end of September.

We suspect that post Q3 2009, there will be investment firms marketing some eye-popping six- and nine- month returns of 100%+.

As we have alluded to before, taking these managers' return numbers at face value would be an incomplete analysis and potentially very hazardous to your financial health.

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Debt: the proverbial double-edged sword

One of the most straightforward ways to “turbo charge” a portfolio’s return is through the use of leverage, or simply, debt. Let’s use a simple numerical example to illustrate debt’s effect on returns².

A fund manager has \$100 million of investors’ money in his fund. He invests the money and the portfolio increases by 20%. In this case, the investors’ return is the same as the amount by which the stocks – in aggregate – appreciated, or 20%.

Let’s see what happens to the investors’ return if the manager was able to borrow a dollar for each dollar of equity he has, resulting in total investable funds of \$200 million. He buys the **exact same stocks** as in the previous example and they appreciate by 20%. In this case, the 20% gain on the \$200 million portfolio is \$40 million. However, since half of the money was borrowed, the **return on the investors’ portion** was 40% (\$40 million gain on \$100 million of equity) and this is the number that goes in the firm’s marketing brochure.

That looks great ...when the portfolio of stocks appreciates. Unfortunately, the same magnification of returns also happens on the downside. If the stocks depreciate by 20%, the debt turns that -20% movement in the portfolio into a 40% loss for the investor.

This use of debt to amplify returns is quite common in certain pockets of the investment management business. Nowadays, a likely area where you could find a money manager using debt to (hopefully) enhance returns is the “hedge fund” world. We put that label in quotes because most of these funds do **nothing** resembling hedging, something we think of as an action to *reduce* risk. And, the one-to-one debt-to-equity ratio we used in our example pales in comparison to what many funds actually use in their operations.

To many, the thought of borrowing to invest may not be something they themselves would feel comfortable doing. If your investable assets totalled \$1 million, would you borrow an

² For the sake of simplicity, we will ignore interest costs. These costs would not affect the principle point, which is to highlight the general effects of using leverage within a portfolio.

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extra \$1 million so you could buy a \$2 million portfolio of stocks? What about borrowing an extra \$3 or \$4 million? Probably not for most folks.

If you wouldn't be comfortable adding 100% or 200% debt financing on top of your own investment portfolio, why would you invest with a manager whose strategy involves exactly that?

It clearly serves investors well to remind themselves to ask the important question of, “How did they do that?” when funds tell you how well they’ve done.

Back to basics: the “math of losses”

2008 was a brutal year for many managers. We were very surprised to see how many managers were down more than 50%. At Silver Heights, we may sound prudish with our oft-repeated mantra regarding the “preservation of capital” but we live and breathe this philosophy for a reason.

We are obsessed with minimizing losses because of the impact it has on long-term results and the difficulty of digging ourselves out of the “hole” created by a permanent impairment of our capital.

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For example, if you lost 25%, you'd need a 33% return to get back to your starting point. A 50% loss requires a 100% return to break even. Here is a table showing varying levels of losses and the required subsequent returns to get back to the starting gate:

<u>Loss</u>	<u>Required return to break even</u>
-10%	11%
-20%	25%
-30%	43%
-40%	67%
-50%	100%
-60%	150%
-70%	233%
-80%	400%
-90%	900%

As is evident, the task of recovering from a loss gets *exponentially* tougher as the losses increase in magnitude. The difference between a loss of -40% and -50%, or -50% and -60% may not sound like much (and the investor quite possibly has curled up into the fetal position and stopped reading their portfolio statements well before then), but the difficulty of breaking even grows by an *incredible* amount as you begin to sustain these levels of losses. And, while 40%, 50%, and 60% losses sound ridiculous, there were *many* managers last year that had the misfortune of delivering such report cards to their investors.

While the industry's Q3 and year-to-date numbers will likely be impressive, it's also important to keep in mind what the longer-term results are for the manager. As we hinted before, we think some funds will be trumpeting 100%+ returns since the beginning of 2009. But, we would also wager that many of these funds posted some hefty losses in 2008. For example, a 100% gain after a 60% loss still leaves the investor in a net *loss* position of 20% (*i.e.*, \$100 → \$40 → \$80). For the TSX index, that **+30% nine-month gain** through September 2009 **turns into a meagre one-year return of 0.5%** if you just include the final quarter of 2008. The last three months of 2008 were just that bad, offsetting virtually all the gains so far in 2009. What you don't see can be as revealing as what you do see.

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Digging out of the hole ...or digging deeper?

Using debt to allow for more equity exposure is but one way investment managers can try to boost their returns. There are many other methods of employing financial leverage, such as derivatives, that can allow managers to achieve *far more* amplified results than what we have described in our plain-vanilla debt example.

The downside outcomes of debt use can be severe. In some cases, they can be fatal. Just think back to some high-profile financial disasters that can be attributed to the excessive use of financial leverage: Long-Term Capital Management, Amaranth Advisors, and the U.S. sub-prime mortgage crisis. Long-Term Capital Management, in particular, is noteworthy because it was founded by individuals from the finance world that had some of the most glorified resumés in the business, including a Nobel Prize winner in economics. At times, it was rumoured that they employed leverage ratios upwards of 100-to-1. As a reference, remember that in our earlier example, the leverage ratio was 1-to-1 (one dollar of debt per dollar of investor equity).

How can such an undoubtedly intellectually brilliant group of people make such an *enormous* mistake? Couldn't they see the potential downside? Of course they could, *but*, the Siren's lure of gigantic returns blinded them to what ended up being a catastrophic outcome. A more cynical view would assert that these investment managers were making a one-sided bet for the "grand slam" because their fee structure let them reap a hugely disproportionate amount of the gain if things went right, yet allowed them to feel far less of the pain if things went wrong.

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Risk-adjusted returns

It can never be emphasized enough, so it's worthwhile recycling a quote from a previous *Perspective*.

*At Silver Heights, we never think of returns in isolation.
We only think about returns on a risk-adjusted basis.*

This simple notion of properly weighing **both** sides of the equation – how much you're likely to lose if things go wrong versus how much you're likely to gain if things go right – is one of the simplest tools that people can use to improve the results from their investing efforts.

Sincerely,



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