Investing Should be a Marathon, not a Sprint

COMMENTARY – JANUARY 2024

In the October (2023) edition of The TANDEM Report, we discussed Tandem's two pillars: 1) our desire to deliver a more consistent, repeatable, and less volatile investment experience and 2) our practicing of the discipline of buying low and selling high. To be frank, we could write about those two things each and every quarter. However, that would surely make for a rather boring quarterly newsletter. This quarter, we'd like to discuss risk and risk-adjusted returns. Specifically, how risk is considered by many investors and how risk feeds into our own evaluations of our efforts.

We believe that risk-adjusted returns are an important element in determining the success of one's investment. Returns are very easily understood. 15% is better than 10%. Easy enough. So, during bull markets most investors pay attention to returns in their basic form, while not always considering the risks that they may be exposed to.

Our goal, as an investment team, is to be an efficient taker of risk. Risk can be defined in many ways. The U.S. Securities and Exchange Commission (SEC) defines risk as "the degree of uncertainty and/or potential financial loss inherent in an investment decision." This definition of risk is fairly easy to understand. Picture all of us gathered around a table in Vegas playing Roulette. I chose to bet $100 on red. In American roulette, my odds of winning would be 47.4%. In other words, I would have a 47.4% chance to win $100 and a 52.6% chance of losing my $100. Fairly simple.

Yet that logic is less easy to apply when it comes to investing. How could one possibly and easily calculate expected potential losses and the probabilities of losing in investing? It's impossible to do it as cleanly as one could standing around a roulette wheel. However, that doesn't mean that this notion and definition of risk ought to be dismissed. On the contrary, it is still an important consideration, even if it is not how Tandem typically thinks about risk.

> During bull markets most investors pay attention to *returns* in their basic form, while not always considering the *risks* that they may be exposed to.

Picture two separate hypothetical portfolios. Portfolio A invests in a portfolio of exciting new startups. The technology coming out of these companies is the future and these companies' technology will surely beat out all of their competitors! Portfolio B invests in more stable and mature names that can consistently grow their businesses through a variety of economic environments. If Portfolio A is successful, maybe the investment will rise 50%. Should the portfolio falter, maybe the value of the portfolio will be cut in half. If Portfolio B is successful, maybe the investment will grow 10% over the next year. If Portfolio B stumbles, maybe the portfolio will decline 10%. If both portfolios are a success, then the investor in Portfolio A looks much smarter than the one that invested in Portfolio B. After all, a 50% gain is no easy task. However, that is not so different from thinking that the most recent Powerball winner is also a genius for having the winning numbers. In both instances, the outcomes were successful – however, the investor in Portfolio A risked a much greater loss. If the two portfolios both falter, the investor in Portfolio B would likely feel better than the one in Portfolio A. B is arguably the safer and more consistent bet.

Warren Buffett once said, "The first rule of an investment is don't lose [money]. And the second rule of an investment is don't forget the first rule. And that's all the rules there are." It's the losses that end up ruining us as investors. A 50% loss in Portfolio A is much more damaging than a 10% loss in Portfolio B. People are typically loss averse – that means that losing $50 is more painful than the joy we experience from gaining $50. Because of this, at Tandem, we believe it is crucial to deliver a more consistent and less volatile investment experience to hopefully minimize the pain from a loss. History has seen a litany of investors that have been littered by the wayside because of loss aversion. The pain felt from losses can cause panic, which can lead to selling low, which can lead to locking in losses permanently.

Losses can also lead to excessive risk-taking. If you have $100 and you lose half, you'd be left with $50. To get back to even, you would need to double your money, or make a 100% return. However, if you had $100 and you only lost a quarter, you would only need to gain 33% to get back to even. By protecting oneself to the downside, one does not need to take as much risk to the upside.

a. 145 King Street, Suite 400, Charleston, SC 29401 *p.* 843-720-3413

That brings me to how we at Tandem typically define risk – which is a little different from the SEC's definition. Usually, when Tandem discusses risk, we are talking about the standard deviation, or volatility, of one's returns. How much volatility does one introduce to achieve one's returns? Let's discuss two separate hypothetical investments. You put $100 in each. Investment A doubles in the first year, then loses half of its value before gaining 25% in year 3. By the end of three years, one would have $125. On the other hand, Investment B gains 7.77% in each of the three years. It too ends up at $125 after three years. To Tandem, Investment B is a more efficient and skillful taker of risk, and more importantly, produces a smoother ride. We would choose to be Investment B, not Investment A.

Now, there are a number of calculations that one could make to determine the efficiency with which one takes risk. At Tandem, our preferred metric is what we refer to as "Risk-Adjusted Returns". To calculate this, one simply divides return by standard deviation of those returns and you end up with a number that tells you how much return one received for the amount of risk that was introduced. Take two portfolios which both returned 10%. The first had a deviation of 20%, and the second had a deviation of 10%. The former has a risk-adjusted return of 0.5 (10 ÷ 20 = 0.5), while the latter has a risk-adjusted return of 1 (10 ÷ 10 = 1). We would say that the second portfolio was better managed, all else equal.

Tandem again differs from most when we consider risk over time. Most evaluators of investment performance want to know what a manager or fund has returned over the past three years, five years, ten years, etc. This has always been a little nonsensical to us. The only time we would care about timeframes like that would be if we thought the next five years were going to look exactly like the past five years. What are the chances that the next five years see a global pandemic, unrivaled fiscal and monetary stimulus, incredible inflation, the rise of interest rates from near 0% to more than 5%, etc. Seems pretty low. So looking at a manager's five year return tells me how they did in that environment, which we believe to be unhelpful for evaluating the next five years. Similarly, people will often want to discuss calendar year performance – but the race did not restart on January 1st of this year. No – the race is ongoing and perpetual.

By evaluating performance over *complete market cycles,* we believe one is in a better position to assess the entire picture, rather than just a snapshot in time.

Unfortunately, I do not have a crystal ball and if I did I would be sitting with my feet kicked back on a beach somewhere tropical. So, I can't predict what will happen tomorrow, let alone what is going to happen over the next five years. To try to evaluate what will happen over the next five years by looking at the previous five seems unlikely to help me. Instead, we choose to focus on performance over a complete market cycle. A market cycle is defined as a period from an all-time high, to a low, back to all-time highs. By evaluating performance over a complete market cycle, in our opinion, one is able to better judge a manager's skill through all markets rather than just one market.

By evaluating performance over complete market cycles, we believe one is in a better position to assess the entire picture, rather than just a snapshot in time. One can see how a stock, portfolio, or strategy fairs through the good times and the bad – take the tortoise and the hare as an example. If one only looks at one part of the race, they might think the hare is the better racer. By looking at the entire picture though, one can see that the slow and steady tortoise crosses the finish line ahead of the hare.

At Tandem, we aim to be the tortoise, not the hare. We aim to deliver a more consistent, repeatable, and less volatile experience. We want to grow your investment and do so with less volatility and we want to do so over complete market cycles – that is how we measure ourselves. We don't pat ourselves on the back if we outperform in a month, quarter, or year. Nor do we beat ourselves up when we trail in any given month, quarter, or year. Those time periods are not relevant in our own internal evaluations. The race is longer than that.

Tandem Investment Advisors, Inc. is an SEC registered investment advisor. This writing is for informational purposes only and shall not constitute or be considered financial, tax or investment advice, or an offer to sell, or a solicitation of an offer to buy any product, service, or security. Tandem Investment Advisors, Inc. does not represent that the securities, products, or services discussed in this writing are suitable for any particular investor. Please consult your financial advisor before making any investment decisions.

a. 145 King Street, Suite 400, Charleston, SC 29401 *p.* 843-720-3413