

Investing in tumultuous times.

2016 began with very weak equity and credit markets. Markets reacted strangely and counterintuitively to data and central bank policy. So, how does one invest in times like this? Ideally, one invests in precisely the same way one invests in calm markets. When the herd is panicking, calm is the scarce resource and therefore valuable. A few principles are worth remembering.

Find the exit before the entry. This is true whether one is investing or indeed doing anything. It is a most general concept. It is fine if the exit is expected to be a tricky one. Recognizing it as such prepares one for the eventuality and advises the enthusiasm of the entry. Sometimes, the exit requires that the market comes to its senses, and sometimes the exit is structurally established. Relying on the rationality of other investors is a risky endeavor, judging by one's own rationality or lack of it. Relying on a structural or contractual exit is better, but the returns are usually commensurately smaller.

There is no return without risk. If there appears to be such an opportunity, then one has failed to identify the source of risk. Risks are not limited to market risk. General conditions can change altering the fortunes of companies and countries. Laws and regulations can change or be open to interpretation. Contracts are not always honored or enforceable.

Compounding is powerful. It is difficult to compound a volatile investment. An investor should realize that losses are inevitable. The nature of compounding is such that you want your profits to compound, that is to grow exponentially, and your losses to be linear. The only way to do that is to limit your losses. The downside to this strategy is that you will leave a lot of profits on the table, which is still preferable to sustaining losses which take too much time to recoup.

Managing losses comes with experience. Investors who have never lost money are either economical with the truth, or have yet to make a loss and are therefore inexperienced in dealing with it and at risk of sustaining a bigger loss than one practiced in the art of losing. Lose often, not big. But not too often for that is when embarrassment takes over.

"Be Fearful When Others Are Greedy and Greedy When Others Are Fearful", said the great Warren

Buffet. This needs some qualification. The market isn't always greedy or fearful, most of the time its just mildly manic depressive. In these in-between states, it pays to be with the herd. How can you tell when there is fear? It's when you yourself are fearful and selling. You will feel awful and feel like selling everything. Until you get there, it's not fear. You must be acutely opposed to buying when you buy.

Managing one's own emotions is at least as important as the cold rational decisions one is supposed to make. Completely removing emotions from investment decisions is almost impossible to do unless one delegates the decisions to a trading algorithm. The patchy performance of such algorithms implies that there are elements of our emotions which are useful in investment decisions, or that algorithms are inherently incomplete. A few rules might be necessary to mitigate emotional biases, such as having stop losses, independent risk managers, diversification rules and time outs.

Don't overdo it. When a great investment idea comes along, do it, but don't overdo it. Wall Street is great at coming up with great ideas but overdoing them, that's why they almost always end in tears. CDOs, CLOs, SIVs, CDS, portfolio insurance, risk parity. At the more practical level, this applies to sizing your investments. You will never have enough of a winning position so make sure you don't for if you do, you might have too much of a losing position. Best to always go away slightly hungry.

Leverage is not a bad thing, it makes good things better and bad things worse. Most importantly, far more important than the multiplier effect, *leverage transfers control over an investment strategy away from the sponsor or equity to the senior lender.* Structure leverage and use it with care.

We are not smarter than everyone else. It is natural to believe in our own intellectual superiority, but in fact we are the average. To avoid turning investing into a game of pure chance we need a sensible process and discipline. Genius is rare and cannot be confirmed.