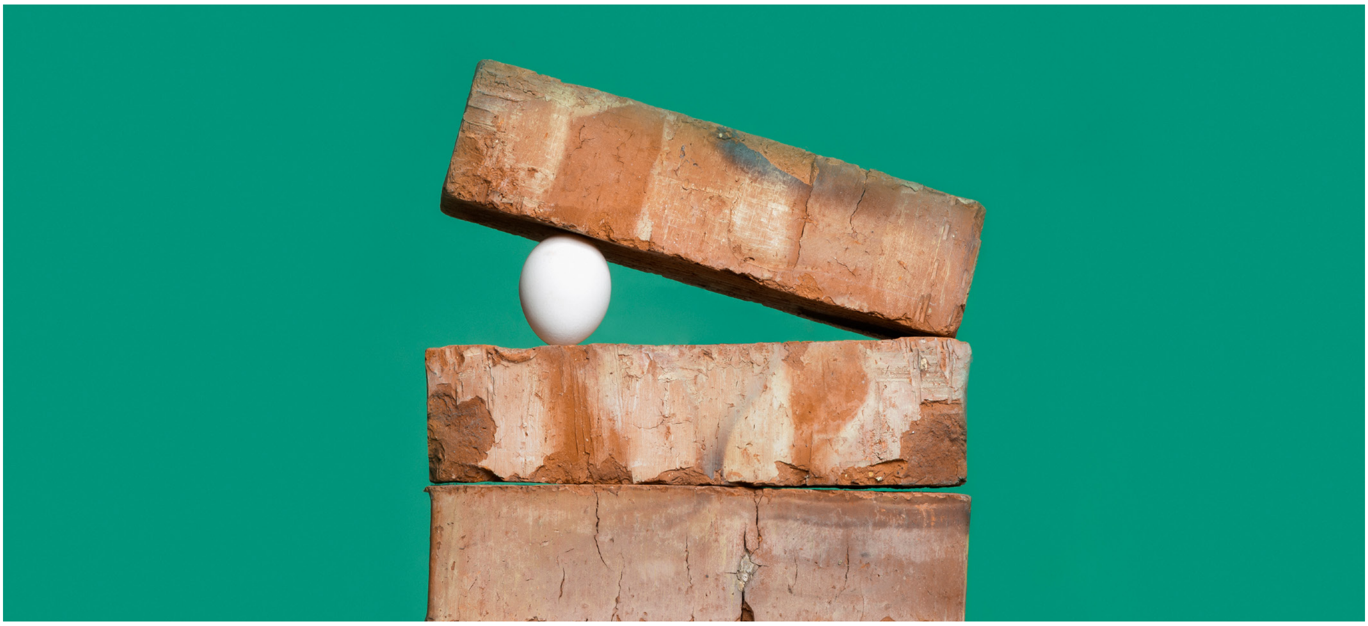

Seven principles of portfolio resilience

Ross Cartwright

The value of portfolio resilience can be underappreciated at times, but it is a critical component of the investment process. Portfolio resilience involves building a portfolio that may help navigate risk events and compound returns in alignment with investors' long-term objectives. This paper identifies seven core principles that are important to consider when seeking to build resilient portfolios.

Why resilience matters today

In the current market environment, there is an underappreciated—yet crucial—ingredient for delivering on investors' long-term objectives. Something that helps manage risk and drive returns through the economic cycle. That ingredient is portfolio resilience.

Defining resilience

Resilience is traditionally defined as the ability to recover quickly from shocks, injuries or adversities. In the context of investing, portfolio resilience is intentionally building a portfolio using a combination of techniques resulting in strong fundamental characteristics. This approach will help the portfolio navigate risk events and compound returns in alignment with investors' long-term objectives.

The theory of creative destruction—weak businesses being taken over or replaced by new ones or technologies—is considered a core pillar of effective capitalism. Historically, this concept has been essential for robust economic growth.

However, the landscape changed dramatically following the Global Financial Crisis (GFC). Instead of allowing the market to self-correct, central banks and governments intervened extensively in markets. Measures such as corporate debt purchases, zero (or even negative) interest rates and quantitative easing helped to prop up companies that might have otherwise faltered or failed.

As a result, the past 15 years have seen remarkable returns in equity markets, undermining the perceived need for resilience. In fact, many of today's market participants have not faced a significant downturn that would have taught them how to identify when capital might be misallocated. We believe this illusion of market stability has led investors to overlook the importance of resilience and for many to assume that policymakers will continue to bail them out, which encourages the continuous pursuit of aggressive risk taking.

In today's market environment, focusing on resilience and building wealth over time seems largely out of favour, yet it is one of our core investment objectives. Resilience becomes paramount when the true risks and misallocations hidden by prolonged market booms eventually emerge. Often, it is not a crisis that destroys capital, but malinvestment leading up to that crisis.

Understanding and integrating resilience into investment strategies is not just prudent, it is critical for navigating the complexities of the current market landscape. Below we lay out seven key principles towards building resilient portfolios.

1. Move beyond financial models to know what you own

While data and financial models are useful tools, they should support rather than dictate investment decisions. Crises are inherently unpredictable, and overreliance on models, which tend to fail precisely when they are most needed, can be risky.

Developing resilient portfolios involves looking beyond data and models to understand the economic reality of companies and applying sound judgment and collective experience when making investment decisions.

While consistent earnings growth is often considered a characteristic of a strong company, that consistency can be detrimental if it comes at the expense of customers, employees or the quality of the company's products or services.

For example, General Electric (GE) was the most valuable company in the world in the mid-2000s. Years of intensive focus on financial engineering through complex accounting practices to smooth out earnings presented a façade of financial stability. This focus, and the resultant culture, led GE's management to ignore underlying problems in its core industrial and financial services businesses, leading to an 80% decline in the stock price between September 2007 and March 2008. Optically, GE's financial data was impressive, but building a resilient portfolio is about identifying fragilities beyond the financial statements and the risks they pose.

2. Understand resilience through redundancy

Nassim Taleb,[1] in his book *Antifragile*,[2] highlights that resilience involves building in some level of redundancy, much like the human body's multiple organs that serve similar functions. This concept of redundancy is crucial for companies aiming for long-term success rather than just optimising near-term growth metrics. Often, the true test of resilience is not during normal operations but during events when what seemed redundant becomes essential.

The COVID-19 crisis exposed the vulnerabilities of margin-enhancing, over-optimised just-in-time supply chains that were finely tuned to specific components or suppliers. The automotive industry, known for its complex supply chains, suffered significantly during COVID when an inability to source simple components severely disrupted their production process.

However, companies that incorporated redundancy and flexibility in their supply chains managed quicker recoveries, demonstrating the value of strategic foresight in resilience building. For example, Toyota's longstanding resilience strategies, like maintaining a buffer stock of critical components, allowed it to manage disruptions better than many competitors.

3. Appreciate the role of innovation

Investing in research and development (R&D) can sometimes be viewed as a low priority, especially when many projects might not lead to immediate results, particularly during tough economic times. However, in a world in which risks and opportunities are emerging at a faster pace, a lack of innovation can undermine the durability of a company.

For example, after the merger of Kraft Foods and Heinz in 2015, the company aggressively pursued cost-cutting strategies, slashing R&D and marketing budgets to drive earnings. As a result, it started to lose market share and fell behind in brand and product innovation as consumer tastes changed. To remedy the situation, it made a bid to acquire Unilever, which failed. That turned investor attention to its growth-through-acquisition strategy rather than organic brand development and innovation. The stock priced plunged 70% over the next two years.

4. Embrace long-term orientation and a culture focused on the future

Resilient companies often distinguish themselves by using challenging times to make countercyclical investments, taking advantage of market conditions such as competitor weakness or acquiring resources at favourable prices to enhance their long-term position. This proactive approach helps to maintain continuity while capitalising on opportunities that arise during downturns.

Resilient companies also demonstrate prudent capital allocation and diversification across products and geographies. Consider companies such as Research In Motion (BlackBerry) or Blockbuster, which relied heavily on a single product line in an industry where change and innovation quickly transformed the landscape. In contrast, companies like L'Oréal showed resilience by diversifying their distribution channels, shifting between professional and consumer products during the 2008 GFC, proactively managing market risks.

Our investment process is founded on a long-term perspective. We focus on companies that exhibit strong fundamentals, including solid balance sheets, durable business models, competitive advantages, high-quality management teams and robust governance structures. By investing in such companies, we believe our portfolios are well positioned to perform over time, even during periods of market stress.

5. Take advantage of compounding

Resilient investing is a journey, adapting as markets evolve. It often requires looking beyond immediate earnings to the potential of a company over a complete market cycle.

It is our belief that earnings drive share prices, and we seek to build resilience by owning companies that can compound earnings over time. As such, our focus is not on quarterly earnings predictions, but on the fundamental question will this company thrive in the next three, five or 10 years?

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The quote

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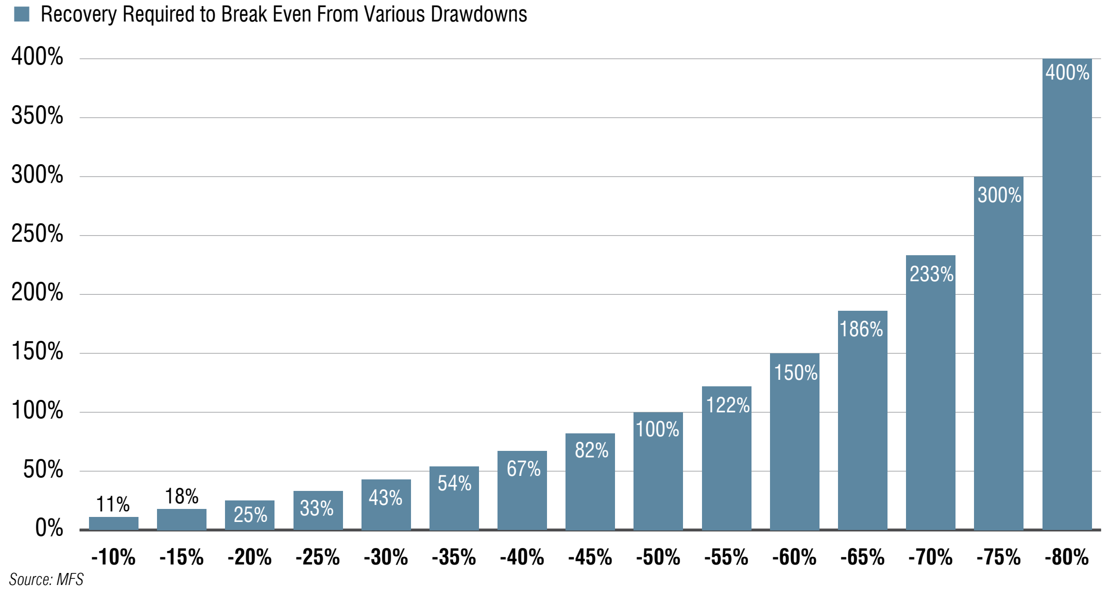
Figure 1. The break-even asymmetry following drawdowns



Source: MFS

Further, we prioritise long-term earnings and cash flow, valuing what a company is truly worth, and assessing what the market is prepared to pay for that today—a perspective often overlooked by the market.

6. See valuation as a cornerstone of resilience

The higher the valuation (the price an investor pays today for future earnings), the higher the risk, as the more an investor pays upfront, the more dependent they become on the company's future performance to justify that cost.

Our approach involves valuation discipline and careful position-sizing at the portfolio level to manage risks effectively. By thoroughly understanding a company's cash flows, how fast it will grow and the risks to that growth, we seek to avoid overpriced assets that could undermine the resilience of the portfolio. This disciplined approach focuses on value, not price and ensures that each investment is made with a clear understanding of its potential return relative to its risk, with the outcome being a more resilient portfolio.

7. Aim for capital preservation and recovery

A resilient portfolio also aims to preserve capital, which is crucial for mitigating losses and enabling quicker post-crisis recovery. Avoiding permanent loss of capital by mitigating drawdowns is fundamental, as recovering from losses requires significantly higher returns.

The ability to manage downside risk allows resilient portfolios to maintain pace through market cycles. Simple maths (see Figure 1) helps explain how a strategy that focuses on downside-risk management can keep pace through a market cycle, even if it does not capture the full upside during strong market rallies.

'Winning by not losing' is a successful strategy when compounding returns over longer-periods of time.

Resilient portfolios do not just survive; they thrive by adapting and seizing opportunities during downturns. The ability to protect capital during declines enables investors to assume greater risks when most likely to be rewarded. This approach is crucial for compounding returns over time.

Resilience as a winning strategy

A marathon is not won though a series of sprints but by navigating the course strategically. Our longer-term focus emphasises protecting our clients' capital, considering both risk and reward to ensure that our investors are well positioned to benefit across market cycles.

We accept that resilience can introduce short-term opportunity costs, but believe the risk of not focusing on resilience is often underestimated.

A resilient portfolio will sometimes diverge from standard benchmarks that often have little to do with the investor's ultimate objective, as it focuses on risks that may not be rewarded by the market.

Further, a resilient portfolio's success hinges on the investment manager's commitment to a consistent process and philosophy. Such consistency not only builds trust but also enables investors to diversify their sources of equity alpha in a constructive manner and align the structure of the broader equity portfolio with their goals.

We believe that now is the time for investors to consider how they can build resilience into their asset allocations, to help meet their long-term objectives. **FS**

Notes

1. Nassim Nicholas Taleb is a statistical mathematician, scholar, author, former trader and risk analyst. His work examines randomness, error, probability, complexity, and uncertainty.
2. Taleb NN, *Antifragile: Things that gain from disorder*, Penguin, November 2012.