The Eighth Wonder of the World

Perspectives from the Canadian Equity Team

April 2018

Of all Warren Buffett's folksy nuggets of investment wisdom, the one that has always fascinated me the most is this:

> "Rule Number 1 is never lose money.
> Rule Number 2 is never forget Rule Number 1."

His starting point in investing is simply capital preservation, and at first, I didn't fully appreciate why. Initially I understood it only at a superficial level: certainly no one wants to lose money.

But upon further reflection, a couple things nagged at me. For one, why is this rule so important if stock markets have generally gone up over time? For example, there are not many 10-year holding periods in the Canadian or U.S. stock markets in which an investor would have lost money.

In addition, Buffett is known as a perennial optimist when it comes to equities. In October 2008, in the midst of the financial crisis, when many in the investment business were cowering under their desks, waiting for the world to end, he famously invested large amounts of cash into stocks.

So why is capital preservation his number one (and two) investing rule?

It may have to do with what Albert Einstein once referred to as the eighth wonder of the world: compounding.

We all know how powerful compounding can be at building wealth over time. $1,000 compounded at just 5% per year becomes $1,630 over ten years: a 63% cumulative return. At 10%, it becomes $2,594 over ten years: a 159% cumulative return, and a vastly superior result.

However, negative returns seriously hurt the ability to compound capital over time. In our 10% example, if we were to replace any one of the 10% years with a single -30% year, the end result is $1,651: almost identical to the 5% result. Even if we compound at twice the return for 9 out of 10 years, just one year of losing 30% is enough to wipe out any advantage.

If we up it to two years of -30%, we end up with $1,050—resulting in almost no change in capital at all, after 10 years. Again, losses seriously impair the ability to generate strong returns over time.

To be fair, 30%+ declines in equities are not that common and are typically associated with recessions. I think that one of the reasons that capital preservation is underappreciated is that the concept is often explained in the context of huge declines that are somewhat rare.

You've probably heard "if a portfolio falls by 50%, then it needs to double to get back to its original value", which is mathematically true, but if these types of declines only happen say once per decade, then for the other nine years why bother thinking about it?

Let's look at some actual market results. The last five years (2013–17) of the S&P/TSX Index ("TSX") have been a very positive time for stocks, with the TSX up cumulatively 51%. Four out of five years were positive, three of those years were up double digits, and 2016 was very strong, up 21%. The one negative year, 2015, was down about 8%, which is hardly catastrophic. This does not seem like a period in which one would have to worry too much about capital preservation.

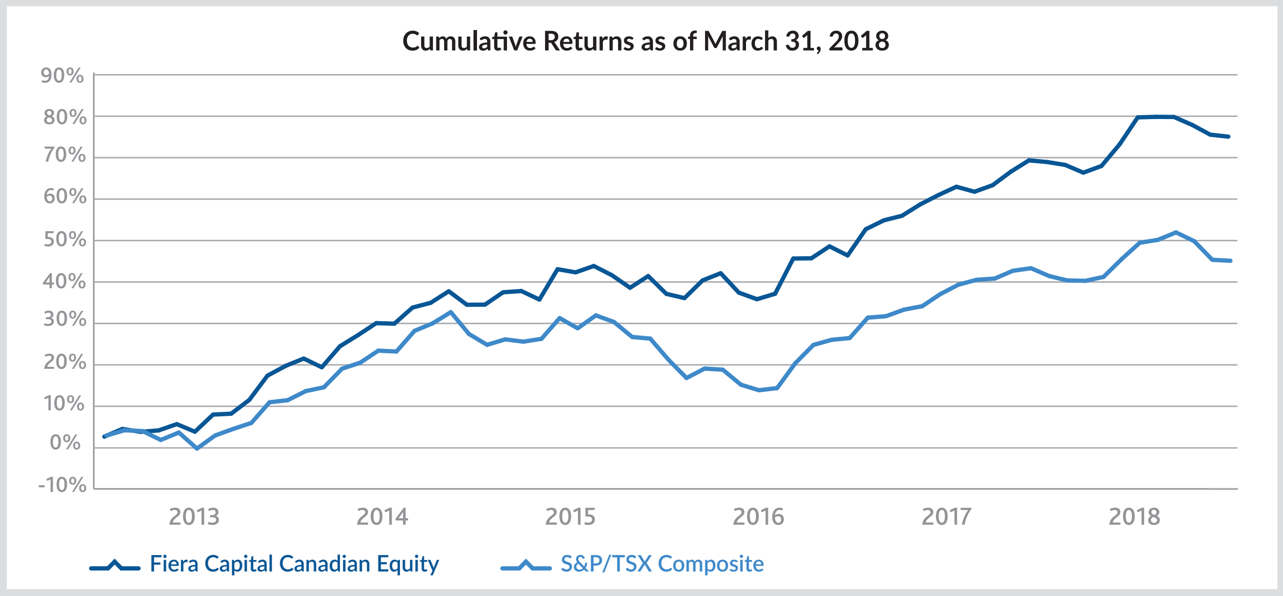
Consider a Strategy that only rose 90% as much as the TSX during the up months and fell 50% less during the down months. It would seem that over such a positive period, this Strategy would be doomed to underperform.

In actuality, this Strategy would be cumulatively up 66%, outperforming the TSX by 15 percentage points. It would have outperformed the TSX in three out of the five years, matched it in one year, and (marginally) underperformed only once, during a very strong 2016.

	STRATEGY	S&P/TSX
2013	14.4%	13.0%
2014	12.5%	10.6%
2015	-0.7%	-8.3%
2016	19.4%	21.1%
2017	9.1%	9.1%
Cumulative	66.4%	51.3%

But how?

Even during bull markets, there are periods of temporary pullbacks. From 2013–2017, there were 19 negative months, so 32% were negative. This is not unusual. From 1980–2017, 38% of the monthly returns were negative. It is very normal for investors to experience negative short-term returns.



A strategy that preserves more of its capital during market pullbacks has, by definition, more capital to take advantage of any opportunities and to benefit from an eventual market recovery.

Strong capital preservation is not just for "bear markets". Having it as a foundational component of an investment process can be a key element in generating superior performance over time.