Valtrust Momentum August 2023:

Predominant Focus On Risk Management

Warren Buffett for a very long time has talked about his two rules of investing.

Rule No.1: Never lose money

Rule No 2: Never forget rule No.1

A simple reading of Rule No.1 would suggest never to book a loss for as long as loss is not booked, one has not lost money. But this is not how Warren operates. When the Corona disaster hit, despite being flush with cash, he booked losses in Airline firms to the tune of a few Billion Dollars. For him, the cost of not booking a loss was the risk of a total wipeout of the investments as Airlines around the world ground to a halt.

Investors see booking losses as accepting that they made a mistake. Behaviourally that is tough and hence one sees investors willing to hold onto losing stocks vs holding onto the winners.

In the world of behavioural science, loss aversion is the tendency to avoid losses overachieving equivalent gains. This combined with endowment bias means that investors are first to book profits and last to book loss when the best path is the inverse. Behavioural biases are hard to overcome. One way to overcome our own biases is to have clear rules on both entries and exits. While this itself shall not eliminate mistakes from happening, it provides a better perspective versus operating in the dark with nothing more than just gut feel.

Our Momentum strategy is one where we apply simple but clear rules that have historically shown to add value. The core objective of our strategy is not only about generating Alpha, but also about controlling risks.

“If you win, you live. If you lose, you die. If you don’t fight, you can’t win!”

— Eren Yaeger

Our strategy requires us to buy stocks that are close to their all-time highs. This means that both on valuation terms as well as expectations, we are way off the median. Sometimes the stock turns out to be a disappointment. This is the reason for the higher churn one sees compared to other strategies. We would rather exit a stock that disappoints than hope for a revival of its fortunes. Our exit rule is not based on where we entered. It is based on whether this is the better stock to be invested in at the current juncture. As long as the answer is yes, we hold on, the day the answer becomes a No, we exit and move to another opportunity.

Like elsewhere, Pareto principle works beautifully in the markets. 80% of our profits are driven by 20% or less of our stocks. The key objective of our risk management tool is to ensure that our mistakes don’t overwhelm our correct decisions.