The Other “R” Word, Rethinking Risk and Return…
A 50 Year Journey

December 12, 2022

The Other "R" Word, Rethinking Risk and Return… A 50 Year Journey

By Neil Nisker,
Co-Founder, Executive Chairman and CIO

Having been in the investment industry since 1972, you would think I've learned a thing or two from working on the floor of the Toronto Stock Exchange, block trading, institutional sales, corporate finance, a discretionary portfolio manager and finally after a brief retirement, becoming an asset allocator as Co-founder, Executive Chairman and CIO at Our Family Office Inc. From a young age, I have always been curious and my capacity to be challenged and learn was insatiable and still is. The dynamic of the investment universe has always triggered my inquisitive nature, intelligence, and creativity and that has been my driving force. It created and sustained my passions for over 50 years. My two passions have been and continue to be investments and philanthropy.

I was always interested in the relationship between risk and return. Understanding risk for me started in 1981, when I was 29 years old and already a 10-year veteran of Bay Street (Toronto's Wall Street). I found my first private equity/venture capital opportunity, which you could say found me. As a daily reader of the Wall Street Journal, I came across an article and learned that 6,000 people in the world died every day because they were drinking water that was impure. I found that tragedy and statistic very disconcerting and inequitable. How could it be possible that so many people died, when I often drank from a garden hose in the summer months.

I felt that I had to do something to try to change that narrative. After much research and several months later, I found a small startup water purification company called Trojan Technologies. After a reasonable amount of due diligence, I raised $1,000,000 for them as a private placement in a private company. The reason I mention this short story is that this investment became the first tenet of an investment philosophy that has served me well ever since. Don't invest in venture capital more than you can afford to lose. In my case I only invested $25,000. I realized that although I thought I could more than double my money, I also recognized that I could lose it all. That socially responsible investment (SRI) went on to be my best investment ever, increasing over 50-fold. Who says you have to sacrifice ROI (return on investment) for ROH (return on humanity). Today, Trojan Technologies, now part of Danaher purifies water for over 2 billion people in more than 102 countries and treats 2.24 billion gallons a day of drinking water for New York City alone.

We all know that there is a relationship between the risk you take to make an investment and ultimately the return. The more risk, the greater the return or the greater the loss. It is much easier to measure return then it is to quantify risk. The most applicable measurement of risk is volatility or standard deviation. Almost every asset class has a standard deviation/volatility or risk metric. There are commonly used percentages for the last 100 years in some asset categories. The most common asset classes with known standard deviation/risk numbers are U.S. large cap stocks at around 18% and U.S.

investment grade bonds around 6%. You can see the relationship that stocks are more than twice as risky as bonds. In the last 93 years, since the October 29th, 1929, crash, stocks have annually returned 9.6% and bonds 5.6%. It's obvious that there is a relationship between risk and return. The greater the volatility, the greater the reward or loss.

Most people have the inclination to do the wrong thing at the wrong time. This has been a topic of greater study in recent years in the field of behavioral economics. Generally, in bull markets people tend to chase assets up as there is a fear of missing out (FOMO). In bear markets or when stocks are down, they often panic and sell, driven by the fear of losing even more money. It is exceedingly difficult to be a contrarian, which is to sell at the height of optimism when assets are always overpriced, for example the Dot-Com Bubble. It is even harder to buy at the peak of pessimism, which my mentor and friend Sir John Templeton taught me some 50 years ago. He would always say “that is when you'll find the very best bargains.”

William Forsyth Sharpe is an American economist who in 1990 with Harry Markowitz and Merton Miller won the Nobel Prize for Economics. He is best known for developing the Capital Asset Pricing Model (CAPM) in the 1960s. CAPM describes the relationship between systematic risk and expected returns and that to earn a greater return you have to take on more risk. He is also widely known for the Sharpe Ratio, a number used to measure the past risk to return relationship of an investment strategy. Every fund manager in the world uses the Sharpe Ratio every time they describe or market their fund’s performance. The Sharpe Ratio is a mathematical measurement defined as the return minus the risk-free rate of return divided by the risk (or standard deviation) to achieve that return. Far be it from me to critique a Nobel Prize winner but let me state three flaws I found in the Sharpe Ratio.

Flaw #1

The Sharpe Ratio only looks backwards at past performance, and it says nothing about future returns. We are all very familiar with the sentence that states: “Past performance is no guarantee of future results”. That statement is on every piece of marketing material in the global investment industry. An analogy I like to use says it more simply. The Sharpe Ratio is like driving a car and only looking in the rearview mirror. If you were to do that, I guarantee you will get in an accident.

Flaw #2

The risk-free rate of return number, the subtrahend, is only known to the manager and there are many different risk-free rate of return assumptions that could be used. They could be the new Libor, which is now the SOFR (secured overnight financing rate), T-bills, treasury bonds, saving account rates, etc. Then there's an issue with which currency you are using and the time frame, overnight or 30 days. If you were to ask 10 different people the question of what is the risk-free rate of return, you would probably get seven or eight different answers. Therefore, the quotient is very suspect.

Flaw #3

If a particular strategy has not been managed through a 1 in 100-year event, a Black Swan or fat tail, then how relevant is the Sharpe Ratio when one ultimately and inevitably occurs? Of course, we have all lived through many 1 in 100-year events, such as the bankruptcy of Long Term Capital Management and the Russian Ruble Crisis of 1998, the Dot-Com Bubble of 2000, SARS and most recently the COVID Pandemic to name some.

So, what did I do once I realized that a ratio that is used by every investment manager in the world has flaws? I wanted to create something of use to every person in the world, not just to the investment professionals and money managers. I wanted people, no matter their net worth, to understand the relationship between risk and return. It took some time, but I ended up creating a new ratio dealing with the shortcomings of the Sharpe Ratio.

I had to deal with the looking backward issue first. Past performance is not unimportant, but only as a guide. No one invests looking backwards. It's all about what one expects to make in the future. Bill Sharpe was brilliant and the first to create a ratio that dealt with the relationship between risk and return, but if what we are ultimately looking for is a simple number to represent this relationship, then why can't we look forward to come up with that number? I started by using Capital Market Assumptions (CMA) for every asset class. How do I think stocks, bonds, real estate, private equity, credit, and lending strategies will perform over the long term? To come up with our Capital Market Assumptions, we look at interest rates, inflation, currencies, make global macro assumptions, price to earnings multiples, earnings growth and more. Many large banks and the Goldman Sachs of the world use CMAs. This gives us a clear idea of what our expectation should be for the next 5 or 10 years.

The second flaw was the risk-free rate of return, which universally is guesswork and invisible to the reader of the Sharpe Ratio. What I decided to do was to eliminate this grey area from the equation.

I came up with a new ratio, the Simple Investment Ratio or SIR Ratio™, which I named after my mentor and friend Sir John Templeton. Every day I get to honor and pay tribute to his memory. The SIR Ratio™ is simply your return divided by the risk you take to earn it. You can look backwards, but this will only give you past metrics, which are really not that important. The SIR Ratio™ is very useful in your approach to Strategic Asset Allocation for the future but can also help in your manager selection.

Strategic Asset Allocation is the most important part of growing wealth and sustaining it. Some 90% of your wealth is created and maintained by your asset allocation. The two asset classes where people have made their first billion dollars are private equity/venture capital and the real estate industry, where one could leverage 75%.
The SIR Ratio™ is a number that the average person can understand. We use the SIR Ratio™ to pick asset classes using our Capital Market

Assumptions taking expected returns of the asset class and dividing that by the historic volatility, which in some cases goes back 100 years. Most of your investments should be in asset classes where the quotient produced is greater than 1. For every unit of risk you take, you should be compensated and get at least one unit of return. Simple enough? The stock market for the last 90 years has had an average return of 10% and its standard deviation was 18%. That means the SIR Ratio™ was .56. For every unit of risk you took, you only received just over half a unit of return. We have many asset classes in our clients' portfolios that have a SIR Ratio™ of well over 2. They include mortgages, private equity, secondaries, hedge funds and credit strategies.

In 2022, stocks and bonds are both down dramatically. Our clients' portfolios have an average of 70% of their investable funds in strategies that have a SIR Ratio™ greater than one. As a result, our clients' portfolios are flat or slightly up so far in 2022. That compares very nicely to a 60/40 model which is down some 20%.

Understanding the relationship between risk and return is paramount in the world of investing. Entrepreneurs put all their eggs in one basket and watch that basket very carefully. They understand that they are taking a lot of risk, with the intention of making a lot of money. Once you have wealth, which describes the family office industry, one should take less risk by diversifying their assets and managing that risk appropriately. We tell our families our philosophy is "stay rich, not get rich". The SIR Ratio™ works well for our clients' wealth and for anyone who simply wants to understand and quantify their past or their future risk adjusted returns.

In conclusion, what I found over the last 50 years that still rings true to me and was an often-debated expression with Sir John Templeton is "It's not how much you make, it's how you keep from losing". If you never have a losing investment in your life, you would probably be the greatest portfolio manager in the world and very rich. My hope is that the wealth management industry, that is mainly focused on returns, will start spending more time focusing on the other "R" word and innovate to help their clients.

A philosophy which I share with our client families is that its incumbent on all of us to try to leave the world in a better place than we found it. By trying to bring a simple metric that can help anyone better understand the relationship between risk and return, I hope that these and the other lessons that I have learned in my 50 years (and not slowing down) will be a helpful part of my contribution.

Thank you for accompanying me on my journey.