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The confusing of risk and uncertainty

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When investing, it is important to differentiate between risks and uncertainties. Uncertainties, in the words of the former US Secretary of State Donald Rumsfeld, are unknown unknowns. Risks, on the other hand, are known unknowns. For example, if you were planning to collect a friend or family member from the airport, the probability that their flight will arrive several hours late is a risk: you know in advance that the arrival time can change, so you can plan accordingly. An uncertainty would be somebody stealing your car 10 minutes before you were due to leave to collect your friend or family. You can't reliably predict the future based on the past events in the face of uncertainty.

So, in simple terms risks can be quantified and certainty cannot.

In the current environment surrounding Ukraine, investors are faced with an uncertainty which is likely to overshadow their short-term thinking. This lack of certainty manifests itself in volatility on a day-to-day basis and will result in asset price volatility until something decisive confirms the future direction of travel. Episodes of geopolitical tension are inevitable, however, and should not overshadow a longer-term investment thesis. Periods of uncertainty provide opportunities for those who do not fall to panic.

Risks are around us all the time. They come in types and in patterns, and can, therefore, be quantified and managed through sound longer-term analysis. Uncertainties come and go and have historically resulted in more volatility in the short term but also quicker rebound in asset prices once a specific uncertainty has been quantified.

The Ukraine Russia issue is highly likely to remain with us for a prolonged period as it is a geopolitical and sovereignty issue which cannot be resolved and can only be managed. As managers of our clients' portfolios, it would be futile speculation for us take a view on whether Russia will or will not further escalate the threat on Ukraine's borders, or whether Ukraine will remain an independent state. Our approach to dealing with these episodes is to reassess the risks to the global economic picture and monitor for contagion in investment markets. At present we see investment markets readjusting but there are no signs of contagion at present. This can be seen in the oil price having pulled back from recent highs even during a period of heightened tensions over the last couple of days.

So, what do we see as the impact of a prolonged period of uncertainty around Ukraine? Firstly, as we have written since 2010, global economic growth will remain sub-trend on a multi-year basis as countries and economies recover from the increased debt levels taken on during the credit crisis of 2008, and now the COVID-19 pandemic. Every politician will talk about increased infrastructure spending and the path to renewable energy; however, it is unlikely, in our view, that this will result in transformative spending or be enough to offset the economic drag of geopolitical tensions and the resetting of trade maps which has actually been ongoing for over a decade. China and the US are in essence creating a bipolar world in which countries such as the UK will need decide which economic model they wish to follow. The UK will follow the US whilst Russia and China are adopting very similar models.

In summary, this period of economic history will be remembered for sub-trend growth rates and reduced prosperity for the majority. In such an environment, companies which can grow their free cashflows consistently will become more and more valuable to investors seeking to preserve their real purchasing power. It will inevitably be volatile, but patience should be rewarded with solid investment returns from a cohort of these companies. Tacit strategies remain invested primarily in such companies and we will use current uncertainty to continue to look for further opportunities.