With a Steady Hand

Essays on Long-Term Investing

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The perils of safety

By Karl-Heinz Thielmann

When, on 10 April 1912, the Titanic departed on her maiden voyage from Southampton, the shipping company, crew and passengers were all convinced that she was not only the biggest passenger ship of all times, but also the safest. According to the experts, her fully automatic flood protection doors, which were designed to seal off the 16 watertight compartments, made her practically "unsinkable". Only five days later, the Titanic had sunk to the bottom of the Atlantic after having collided with an iceberg. Two-thirds of the ship's passengers drowned.

Speed Read:

- If investors assume assets to be safe, they are neglecting dangers and hidden risks.
- The perception of safety changes over time. What has been safe in the recent past is regarded as safe by investors, ignoring historical experiences.
- Safety is impossible because its precondition is that nothing changes in the future. Therefore, the assumption that there are safe investment opportunities is an illusion.
- The quest for safety may actually cause risk because the awareness of safety can make people careless.

Today, we still often cite the Titanic as an example of excessive faith in technology. However, above all, it is a good example of how people put themselves at risk when they feel too safe. Indeed, the shipping company and the captain behaved very imprudently because they trusted the ship's excellent technical standards. In spite of iceberg warnings, the ship maintained its course at full speed into a danger zone. The sailors in the crow's nest of the luxury steamer did not have binoculars and could not see far at night time. After the collision, it materialised that there were not enough places in the rescue boats.

Before 2007, many investors bought so-called CDOs, many of which were rated AAA by the rating agencies, and therefore considered very safe. Once again, expert opinions had fostered a false sense of safety. The investors purchased the securities without assessing or understanding their risks, because they trusted anonymous rating analysts. We all know the consequences. A few months later, as a result of the financial crisis, many bonds - which had previously been considered highly safe - were virtually worthless.

In recent years, this quest for safety has resulted in a huge demand for the government bonds of the major industrial countries such as Germany, USA or Great Britain. Investors buy them without paying attention to the yields. But just how safe are these securities in reality?

Their reputation as "safe" is mainly grounded in their minimal default risk and liquidity risk, even if investing in bonds has also always involved taking small price risks. However, people have carelessly neglected the fact that the low default risk of government bonds is accompanied by a high degree of vulnerability towards inflation.

If British or American investors had been told in 1970 that government bonds were safe and stocks unsafe, they would have shaken their heads pityingly. These countries were just coming to the end of a long phase of "financial repression", during which the inflation rates often exceeded the interest rates of government bonds. As economic growth was high at that time, Great Britain and the USA conveniently replenished their budgets at the expense of the buyers of gilts and treasuries.

Controlling the economy with the tools of Keynesian fiscal and monetary policy seemed to be possible. A large number of economists and politicians believed that growth and employment could be guaranteed even if it entailed putting up with a bit of inflation.

In that economic scenario, it is clear why stocks appeared to be safer than fixed-interest securities. They benefited from constant economic growth and seemed to be only minimally affected by inflation. For this reason, they were also justifiably rated very highly. In some cases, the P/E ratios rose significantly above 50 for stocks, which had the reputation of generating stable income growth. Fixed-interest bonds, on the other hand, were latently threatened by inflation. It was only when Paul Volcker was appointed President of the Federal Reserve in 1979 that combating inflation became top priority and this trend was reversed.

Half a century earlier, investors were shocked by the great stock market crash of 1929. Some of them sought a safe haven and purchased bonds instead of stocks. Similarly to recent times after the financial crisis of 2008, the yields of US treasuries fell persistently to a low of under 2% in 1940. Stocks remained volatile for more than decade. However, ultimately, the wealth of bond buyers was crushed by inflation in the coming decades, whereas the stock market recovered after a while.

If investors seek safety by pumping their money into overvalued securities, they risk facing massive revaluations. In 1970, exorbitant valuations of "safe" stocks were the harbinger of the price slumps to come. At the moment, like in 1940, the extremely low interest rates for "safe" securities are a sign of an imminent trend reversal.

But, if we take a closer look, is safeity at all possible?

It is defined as the absence of surprises in the future. Mostly it is associated with an absence of negative events, and is therefore perceived positively. In real terms, however, an absence of surprises also means that nothing can improve.

In reality, surprises occur - both negative and positive ones. Something unexpected can happen at any time and have dramatic consequences. A negative example is the 9.11 terrorist attacks; a posi-

tive example is the advent of penicillin in 1928, which was accidentally discovered when tidying away a forgotten mould culture.

We cannot forecast certain things, and can therefore not feel "safe" from them, because there are limits to the scope of human imagination. Indeed, we fail - time and time again - to predict the destructive and foolish behaviour of other people. Many things only appear to be safe but are in fact dependent on everybody involved behaving sensibly. To rely on this assumption can, however, be fatal. According to Albert Einstein, "two things are infinite, the universe and human stupidity; and I'm not sure about the universe." The Titanic was only unsafe because it headed at full speed into waters with icebergs. CDOs seemed to be safer than they were because the rating agencies' risk models were based on flawed assumptions. Government bonds become unsafe when they receive absurdly high ratings, which prevents them from maintaining their value after inflation.

Fail-safe investments are an illusion. Those seeking only safety invest carelessly and inevitably end up disappointed - at best with low yields, at the very worst with high losses due to hidden risks. Those that are aware of the dangers can take counter-measures. Only those that are lured into a false sense of safety are heading for a nasty surprise.

Negative surprises can never be avoided entirely as they cannot be predicted. Nevertheless, investors can implement investment strategies that minimise their impact. Simply seeking "safe" investments is therefore not the most effective approach to risk management. It results in risk being concentrated in segments harbouring dangers that investors ignore or cannot imagine. Instead, risks should be as widely diversified as possible so that they can balance each other out.

Curriculum vitae of the author:

Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlshochschule International University in Karlsruhe.

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