

# The Prince that Never Dies

## The Case Of Dmitry Ivanovich

Medieval Europe was not an easy era to be the heir of a feudal lord; it was not uncommon for a claimant to be *made to disappear*.

To the enterprising, however, a disappearance was a prime opportunity for career advancement. Born a meager nobleman? Not a problem. Simply persuade the people that you are the missing Lord or Prince and, when you ascend the throne, get rid of anyone who would say otherwise. It was remarkable how quickly the public could forget the past. And yet no case was more unbelievable than that of the three Dmitrys, which occurred between 1603 and 1611, when no fewer than three men claimed to be the resurrected Dmitry Ivanovich, third son of Ivan "The Terrible" of Russia.

The case of the three Dmitrys transpired because of an act of evil committed by the Russian *boyar*, Boris Godunov. A cunning man with a long, dark beard and an unquenchable thirst for power, Godunov was the brother-in-law of Feodor I, the second son of Ivan "The Terrible." Originally in Ivan's

inner circle, Godunov was a brilliant strategist who was ruthlessly addicted to power. When Ivan IV died and Feodor I became tsar, Godunov used the youth's mental illness to become the behind-the-scenes ruler of Russia.

Since Feodor I had no direct heirs, Godunov's only threat to absolute rule was nine year old Dmitry Ivanovich who was next in line to the throne. In order to secure his future as tsar, Godunov needed to take care of Dmitry. He had the little boy murdered and elected himself as Feodor's successor.

But Godunov's problems with Dmitry were only beginning. In 1600, rumours began circulating that the young prince had miraculously survived the assassination attempt and had risen again! On cue, in 1603, a young man came forward claiming to be the missing prince. His story proclaimed that Godunov had mistakenly murdered another boy in his place, and he had travelled from monastery to monastery to avoid

capture. False Dmitry I was not only able to gain the sympathies of the Russian public, but of England as well. It was this widespread support that enabled him to acquire an army of his own and eventually become tsar. Not bad for an upstart with no real royal blood. Regrettably for this Dmitry, his reign as tsar would be cut short by Godunov allies who disagreed with the appointment.



Boris Godunov  
Regent of Russia (*de facto*)  
c. 1585 to 1598

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Dmitry Ivanovich would miraculously rise not once, but twice, after this. This was crazy. Not only were all three imposters ambitious enough to fake a royal identity, but the Russian public was willing to believe in each subsequent resurrection as well. As the False Dmitrys demonstrate, people will believe what they want and are quick to forget the past.

This apparent shortness of memory is a lesson seasoned investors know well. Even after a market collapse, when investors feel the sting of losses keenly and become hesitant, there comes a time when investors acquire the stomach for risk again. It does not matter how much pain the last crisis caused. Risk appetite eventually returns.

The past year appears to have marked the return of risk appetite. Nearly four years after the U.S. subprime market burst, triggering a near meltdown of the financial system and a global recession, the shock finally appears to be wearing off. Investors are forgetting 2008/2009. And as the fear of uncertainty declines and jealousy and greed take over, asset classes perceived as “riskier” are becoming more popular again.

The return of risk appetite is evident on a number of fronts: equities are now at or above long-term average valuations; low quality borrowers are raising debt in public markets at a rapid pace; and synthetic products like collateralized debt obligations (CDOs), the very products that helped undermine the financial system five years ago, have re-emerged. Even Cinda, the state-backed bank in China that takes on bad Chinese loans, was able to go public with huge interest from investors who were trying to *gain* exposure to China's bad loans.

The renewed confidence can also be seen by looking at the nature of equity returns last year. In 2013, all of the Mawer equity mandates produced double-digit returns – our small cap mandates even generated over 40% each. How could this be possible in a year of lackluster economic growth and mediocre corporate earnings? While it would be great to say that all our equity investments posted stellar earnings growth, in reality, they broadly benefited from re-pricing in the market.

To some investors, the return of riskier investments may seem as crazy as Russians believing in a thrice-assassinated prince. But is this

resurrection really so out of the ordinary?

We don't think so. Risk appetite may be labelled a rational process, but in our experience it is much more a byproduct of the human condition. A human condition that is inherently prone to cycles of behaviour.

If risk appetite truly has returned, then it is important for our clients to understand how this might affect the odds of investment success. That is why we spend some time in this year's annual letter exploring the appetite for risk, how it evolves, and how it relates to the investment landscape. By exploring these factors, we hope our clients will be in a position to make better decisions than our 16th century Russian counterparts.

## A Bet With Boris

To properly appreciate risk appetite, it is important to first distinguish between “risk” and “uncertainty.” This can be accomplished by a simple thought experiment.

Imagine you are hanging out with Boris Godunov at a coffee shop in Moscow. Ever the gambler, Boris hands you a die and offers you a

deal. If you roll a 1, 2, 3, 4 or 5, Boris will pay you \$50,000. But if you roll a 6, Boris gets your house and your second child. You have no idea what is going to happen when you roll, but you know you have six possible outcomes. This is risk. It happens when you know the future distribution.

Now imagine that Boris again gives you a die to roll with the same bet, except this time, the scheming Russian gives you a die with an unknown number of sides. Now you have no idea what is going to happen, and you have no idea how many possible outcomes there are. Sneaky Boris. This is uncertainty. It happens when the future distribution is unknown, or so large that it is functionally the same.

This distinction between risk and uncertainty, originally proposed by economist Frank Knight, may be somewhat technical, but it does present an important question in our discussion. Namely: when are investors ever really dealing with risk?

Therein lies the rub. Investors are almost always dealing with uncertainty. There are virtually no situations in investing when the future outcomes can be accurately measured or the future probabilities

reliably known. Investors simply don't know the actual distribution of future outcomes.

This fact complicates the goal of making individual decisions based on a logical assessment of risk and reward. But it only makes the task more difficult, not impossible. Even if investors do not know the odds, it is still reasonable for them to act, so long as they have what Keynes called a "rational belief."

Keynes believed that it is fair for an individual to act, even if he cannot know the true odds (i.e., the future distribution), so long as he acts based on a belief that is rational. In other words, even if the risk of something cannot be known, an investor can still act if there is some solid reasoning to do so; and that "reasoning" typically relies on empirical evidence or a pattern from the past.

Since this is more easily understood with an example, let's return to the Russians. Were the Russians technically wrong to believe that the young prince had thrice escaped assassination? No. At the time of their belief, there was some possibility that Dmitry had survived, however utterly unlikely that seems to us today.<sup>1</sup> It just wasn't very rational. Likewise, we

don't know for sure that the sun will rise tomorrow or if the Leafs will win the Stanley Cup next year. But it seems rational to believe in one and not the other. (We know how we'd bet.)

What makes this even more interesting is the role that perception plays in all of this. Humans are not always gifted at estimating the odds under normal conditions, but we are especially bad at making decisions when we *perceive* uncertainty.

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<sup>1</sup> But who knows? Maybe Russian politics were so unusual back then that their belief wasn't so crazy at the time.

" ... as this visual demonstrates, the rider only gets to steer when the elephant doesn't decide to stomp around or run away from the proverbial mouse."

This is because the perception of uncertainty elicits a strong reaction of fear. And in the battle between a rational process like risk assessment, and a deeply rooted emotional reaction like fear, there is a tendency for one particular side to win.

## The Rider And The Elephant

Psychologists have spoken for several decades about the two separate systems at work in our brains: a "rational" system and

an "emotional" system. While our rational system is thoughtful and logical, our emotional system is impulsive and instinctual.<sup>2</sup> Understanding the way these systems interact sheds much light on an investor's appetite for risk.

In *Switch: How to change things when things are hard*, Dan and Chip Heath use an image to illustrate this relationship. They ask their readers to imagine a rider sitting on top of an elephant. The rider is your rational system, which is responsible for logic and reason.

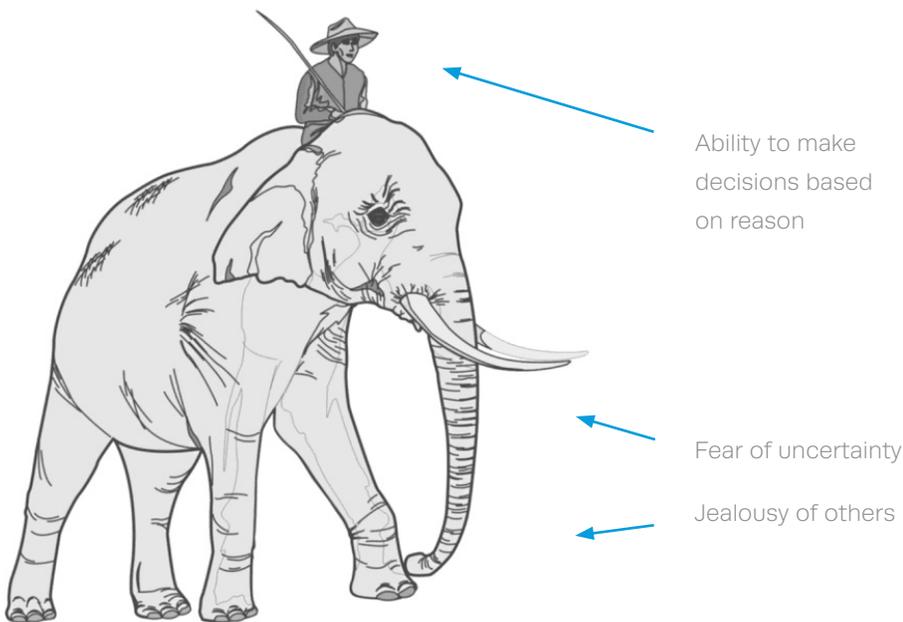
The elephant, on the other hand, is responsible for emotions like fear, hubris and greed. It is easy to see how everything goes smoothly when the two are in alignment. But who do you suppose wins in a disagreement?

This visual also helps to illustrate our understanding of risk appetite. Making investment choices is inherently about making a decision based on a rational assessment of the possible odds and outcomes. To accomplish this, we must use the logical part of our brains. Risk appetite, therefore, ought to be the domain of the rider. But it is often not, and that is because the perception of uncertainty creates fear, which operates in the domain of the elephant. Thus, risk appetite is a byproduct of the pull between the rider (rational forces) and the elephant (emotional forces). And as this visual demonstrates, the rider only gets to steer when the elephant doesn't decide to stomp around or run away from the proverbial mouse.

Why is the human reaction to uncertainty so strong? While no one knows for sure, psychologists have determined that the reaction to uncertainty seems to be rooted in our amygdala, the part of the

Who wins in a disagreement?

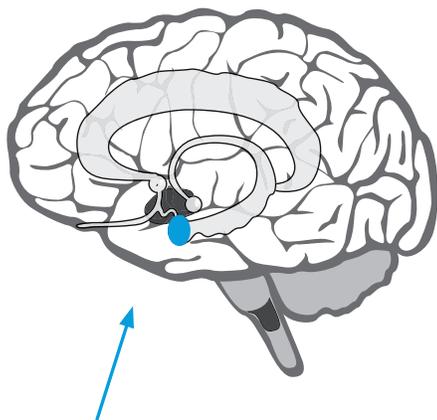
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<sup>2</sup> Chip Heath, Dan Heath, *Switch: how to change things when change is hard*. (New York: Random House, 2010).

brain that is responsible for our primordial fight, flight or freeze response. This is the part of the brain that existed long before humans developed the capacity to reason.

Using this psychological theory, it is easy to see why it would have been difficult for many individuals to invest in equities in 2009, even if the case seemed compelling from a risk-reward standpoint. Back then, the investing world felt uncertain. It did not matter that real discount rates were likely in the double digits, earnings levels were depressed, dividend yields were greater than bond yields, or that some excellent companies traded for less than their book values. It



Amygdala, n. The part of your brain that encourages you to sell your entire stock portfolio at the bottom of the market

did not matter that economics had been shown to have no correlation with investment returns. And it did not matter that there was enough evidence for “rational belief.” The health and direction of economies seemed uncertain and this uncertainty was enough to scare investors. For many, the elephant won.

This visual also shows how investors may be driven by the elephant in 2014. As one might guess, fear is not the only emotion that directs the elephant. On the other side of the spectrum is greed and hubris, which are both influenced by the feeling of jealousy. And it is easy to see how jealousy can impact investors in a period of increasing risk appetite.

When the Joneses next door buy a new BMW or renovate their kitchen, it is difficult to avoid making comparisons and feeling inadequate. Likewise, investors who had the majority of their portfolio in bonds in 2013 might look at the near 50% returns of our small cap managers last year and conclude that they should weight small cap companies more heavily in their portfolios, whether or not this move aligns with their time horizon and risk tolerance, and whether or not the same opportunities in small cap companies exist. It is normal to compare oneself to others.

## Of Rats and Men

How does an investor's risk appetite transition from one preference to another? The answer can be partly explained by the failed brain surgery of a rat.

In 1954, two postdoctoral fellows at McGill University implanted electrodes into rats' brains so that they could run experiments on them. The researchers, James Olds and Peter Milner, used the implants to deliver mild electrical currents to specific parts of the rats' brains. But in one of the rats, the electrode accidentally dislodged from its intended place and moved into an unanticipated part of its brain. It was this accident that allowed Olds and Milner to make one of the biggest discoveries of their career.

Olds and Milner placed the rat in question into a box with corners marked A, B, C and D. The rat was allowed to roam freely unless it moved into

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Corner A, when it would receive a mild electrical shock. The experiment continued in this way for some time until the researchers noticed something peculiar: rather than avoiding Corner A, the rat kept returning to it. Something about the electric shock was pleasurable to the rat. To test their hypothesis further, Olds and Milner tried to get the rat to move to other corners of the box by inducing mild, electric shocks. When this also worked, the fellows knew they were on to something. Olds and Milner had discovered a pleasure center in the brain and figured out a way to use this feedback to incent behavior.

Markets provide positive and negative feedback to investors in a way that is similar to this experiment. When a stock goes up in price, investors receive pleasurable feedback. When it goes down, investors feel a negative response. Our brains respond to price movements in a way that makes investing “exciting” for many.

But does the feedback, whether positive or negative, make the “investment” box any better or worse for the investor? Not typically. The mood of the market is often an overreaction to the actual odds.

This last point about the market allows us to connect our discussions on uncertainty, risk, and how risk appetite is formed, as it draws attention to an important question: *is there ever really any more or less uncertainty, or is there just more or less perception of it?*

From our discussion on Boris, we know that investors are always dealing with uncertainty. While the media likes to talk about “heightened” periods, it is hard to imagine how there could be more unknown of the unknown. It is simply impossible to know.

Regardless, humans seem to perceive there are situations where there is more or less uncertainty. And while this may not be the case in reality, the mere perception is enough to impact risk appetite. Whether or not uncertainty actually diminishes, when it is perceived to diminish, fear reduces. The rider has more of an ability to control the elephant and the elephant is likely to become more motivated by things like greed or jealousy.

Consider the current environment. With all of the recent confidence, there seems to be some agreement that somehow the world is less uncertain than it was 18 months ago. But how is that possibly true? Global economies are no more predictable today than they were 18 months ago, nor are they any less adaptive or complex. If we are honest with ourselves, the only part of uncertainty that has changed in the last 18 months is our perception of it.

## Final Thoughts

There is an adage that says to be careful what you wish for because it might come true. In investing, there is an extent to which the mere perception of the odds influences the results. It is a curious phenomenon, akin to what would happen if your opinion on the weather tomorrow actually influenced whether it rained or shined.

Whether or not the return of risk appetite is merited, it has had an impact on valuations of certain asset classes. As investors have become more confident in the future, they have become more willing to pay today for future streams of cash flows. And it is not only in equities but in other

asset classes, like corporate bonds, where we are seeing this phenomenon play out. Low quality corporate borrowers with BB+ ratings, for example, have seen the cost of borrowing in public markets fall as investors have become more comfortable lending to them.

In equities, it would be reasonable to say that the long-term return potential for most stocks has probably deteriorated. Of course, we cannot say this for certain. It is possible that interest rates remain at these low levels forever or that the significant growth expectations implied in many stocks is realized and continues into the future. If either of these scenarios was to occur, and both are possible, then equity valuations are not as mediocre as some are saying. Maybe the Leafs do win the Cup next year.

However, there is some reason to believe that the long-term return potential in equities has legitimately worsened since 2009. The major bourses have all rallied significantly since the crisis and stock returns have been driven more from multiple expansions than impressive earnings growth. When our team looks at the valuations in our discounted cash flow models,

the internal rates of return we expect – a proxy we use for the average return we expect over the long-term on a stock – tend to be in the 7 to 8% range. This compares to a 9 to 12% range that we saw in the years immediately following the crisis and the 8.4% that \$1 would have earned in the U.S. equity markets between 1824 and 2013.<sup>3</sup> These odds are not the worst we've ever seen, but they are not the best either.

Of course, valuation exercises such as these only serve as proxies for the very long-term. They are not indicative of what could happen over the next year. Moreover, the range could just as easily be 5% or 9% over the long-term, as there is a wide range of error around these estimates. The truth is, we just don't know.

What these numbers do provide are some guideposts and perhaps enough evidence to support a "rational belief," which in turn allows us to position our clients' portfolios in a way that is most resilient.

Ultimately, it is in the investor's best interests to tame her inner elephant. At Mawer, our systematic process is our best line of defense against getting swept into the herd of elephants that is the emotions of

the market. By thinking "micro, not macro" and playing a long game, we not only distance ourselves from the daily signals that trigger our emotions, we end up focusing on guideposts we believe are better for estimating future odds. Of course, while we cannot know what the future holds and our method is not the only way, it is the way we have found most reliable over time.

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<sup>3</sup> Merrill Lynch's 100 Year History of Charts

