

GRC NEWSLETTER 09 | 2025-12-31 | UNDERSTANDING RISK

Dear Shareholders,

In this newsletter, we introduce a conceptual framework we have been developing to better understand and communicate the nature of active management risk. Drawing an unlikely parallel from the world of financial auditing, we believe this model offers shareholders a clearer lens through which to evaluate our investment process and set realistic expectations for fund performance.

The Conceptual Bridge: From Auditing to Investing

Financial auditors employ a well-established model to decompose the probability of issuing an incorrect opinion. The audit risk model states that Audit Risk equals the product of Inherent Risk, Control Risk, and Detection Risk. Each component represents a sequential filter that must fail for an audit to miss a material misstatement.

We observed that active investing presents an analogous structure. For outperformance to occur, multiple conditions must align: the market environment must favour your strategy, your stock selection must be sound, and your execution must be disciplined. When any of these elements fail, underperformance becomes the likely outcome.

The Investment Risk Framework

We propose the following decomposition of active management risk:

$$\text{Outperformance Probability} = (1 - \text{Regime Risk}) \times (1 - \text{Selection Risk}) \times (1 - \text{Implementation Risk})$$

Or equivalently:

$$\text{Underperformance Risk} = 1 - [(1 - \text{Regime Risk}) \times (1 - \text{Selection Risk}) \times (1 - \text{Implementation Risk})]$$

The Three Components

1. Regime Risk

Regime Risk represents the probability that macroeconomic or market conditions are unfavourable to our investment style. This includes factor headwinds, correlation breakdowns, liquidity regime shifts, and structural market changes. Even the most skilled stock picker will struggle if the broader environment works against their approach—value investors suffered through much of the 2010s, while momentum strategies periodically experience sharp reversals.

2. Selection Risk

Selection Risk captures the probability that our stock-level analysis contains material errors. This encompasses thesis errors, missed competitive threats, misjudged management quality, overestimated moats, or underappreciated balance sheet risks. It is the risk that we have identified the wrong companies, even if the market environment would have been favourable.

3. Implementation Risk

Implementation Risk reflects the probability that execution undermines otherwise sound decisions. This includes poor entry timing, incorrect position sizing, premature exits, failure to rebalance, behavioural errors under stress, and lack of process discipline. Many good investment theses have been rendered unprofitable by poor implementation.

Why This Framework Matters

It explains why active management is difficult

Consider an investor with above-average skill at each stage: regime conditions favour them 60% of the time, their stock selection is correct 70% of the time, and their execution is disciplined 80% of the time. Their outperformance probability is only $0.60 \times 0.70 \times 0.80 = 33.6\%$. The multiplicative nature of sequential success explains why even skilled active managers frequently underperform.

It identifies where to focus improvement efforts

The framework reveals which component offers the highest marginal return on improvement. A manager with 90% selection accuracy but only 60% implementation discipline should focus on process and behaviour, not refining their already strong analytical capabilities.

Application to Global Rational Capital Fund

We have designed our investment process to systematically address each risk component:

Risk Component	Our Tool	How It Mitigates Risk
Regime Risk	Market Health Index (MHI)	Systematic scoring from -2.0 to +2.0 guides tactical allocation and cash positioning based on market regime detection
Selection Risk	14-Component Scoring Framework	Comprehensive analysis across Quality, Stewardship, Growth, Scalability, Predictability, Macros, Catalysts, Risks, Resilience, Sentiment, Momentum, Valuation, Asymmetry, and Timing
Implementation Risk	Systematic Rules & Process Discipline	Pre-defined position sizing rules, systematic rebalancing triggers, and documented decision processes reduce behavioural errors

Setting Realistic Expectations

This framework helps us communicate candidly about performance expectations. To achieve only 10% underperformance risk would require approximately 96.5% success rates across all three components simultaneously—a level of consistency that is unrealistic even for the most skilled managers.

For a concentrated global equity fund targeting ACWI outperformance, we believe a more realistic aspiration is underperformance risk in the range of 30-40% over rolling three-year periods. This would require success rates of approximately 85% across each component—demanding, but achievable with rigorous process discipline.

We believe transparency about these realities, rather than overpromising, builds the trust necessary for long-term investment partnerships.

Future Development

We are committed to continuously refining our processes to reduce risk across all three components. For Regime Risk, we are enhancing our Market Health Index to improve early detection of unfavourable market conditions and guide more timely tactical adjustments. For Selection Risk, we are iterating on our 14-component scoring framework—refining weightings, incorporating new data sources, and stress-testing our analytical assumptions against historical outcomes. For Implementation Risk, we are strengthening our systematic rules and decision documentation to further insulate the portfolio from behavioural errors and execution drift. This pursuit of incremental improvement across each dimension is central to our investment philosophy.

Closing Remarks

We present this framework as experimental—a thinking tool rather than a definitive model. We welcome your feedback and questions as we continue to refine our approach to understanding and communicating investment risk.

Thank you for your continued partnership and trust.

Warm regards,

Robert Tate

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Global Rational Capital Fund