Embracing Market Risk

Investment success over the long term truly begins with a real understanding of risk – a concept which too often is associated with volatility instead of with actual loss. When operating with an investment vision that extends over 5 to 10 years, investors will see their portfolio values rise and fall across market cycles, fluctuations likely to cause consternation from time to time. In the end, however, diligent selection and patience are likely to keep value in the portfolio.

This focus allows us to define risk, not in terms of volatility, but as true loss of capital. Changes in the market's value do not result in real losses unless investors are selling off their holdings; we aim to perform better by staying attuned to true risk and quieting the noise of volatility.

Financial markets, on the other hand, have largely defined risk in terms of volatility: the variability of results around an expected outcome. These results are expressed as the prices for securities. Mathematically, the variability of results is calculated as the standard deviation of results around the mean and it often takes the shape of a bell curve, the top of which represents the most often observed number of results. The bell curve drops off in either direction into "tails." The likelihood of a result occurring in one of the tails is small by comparison to the likelihood of the result occurring in the center of the bell curve. Thus, the unexpected results represent "risky" outcomes.

While conflating risk and volatility may be helpful in selling a product that purports to dampen volatility, for the long term investor and, in fact, for anyone operating in the real world, this is too narrow a definition of risk. Our view is more akin to that of Warren Buffett, who also notes that risk means the permanent loss of capital.

There needs to be an acknowledgement of risk taken for potential return achieved. But when investing, the markets provide a very special setting for risk-taking. If risk represents the permanent loss of capital, then we don't have to recognize the losses incurred when specific stocks sell off. We can hold that stock, believing that eventually the market will recognize the value we saw when we first purchased it.

Indeed, understanding the value of individual holdings is a cornerstone of this philosophy. The market may frequently dictate price, but stocks will often eventually level-set at their underlying value. It becomes critical to know what stocks you own, appreciate their value, and have confidence they will weather some market cycles.

With this in mind, we should actually embrace marketplace variability since it means that sometimes the market will sell off and other times it will rally, both beyond our expectations. Fear and greed in the marketplace create these extremes, and with them come opportunities to buy when the market has sold off – and to sell when greed is widespread and the market rallies.

In these peaks and valleys, we can sharpen our analytical approach, conduct good research, and discern the important difference between price and value. This is how we can use volatility to our advantage, for we will know when a security is attractively valued and when it is priced too dear. Without knowing the difference between price and value, we are unable to use volatility constructively. And without knowing if the security is overpriced or underpriced, we should sit aside.

Financial markets have taken the earlier definition of risk, the one we feel is too narrow, and have really run with it. We think the practitioners who subscribe to this concept of risk as being based on the variability of results have lost an important perspective. Some of the work done by researchers since Harry Markowitz's landmark article in the *Journal of Finance, Portfolio Selection*, in 1952, has helped to develop important concepts around portfolio construction. Topics such as diversification, and even the efficient frontier of portfolios with optimal blends of risky assets, are indeed useful in building portfolios.

But today's practitioners have taken these concepts to extremes. Cheap and accessible computing power has allowed these practitioners to build portfolios based on historical patterns of low-correlation assets and attractive historic asset performance. Without an exhaustive attribution analysis based on multi-factorial variables, it is really impossible to say with certainty what has caused the outperformance or the low correlation. Too often these portfolios are then constructed and produce disappointing returns going forward. This is done all in the name of risk-reduction and return enhancement. Unfortunately, the result is the opposite: return reduction and risk enhancement.

Optimal diversification is usually achieved by using 30 to 40 stocks representing a broad cross-section of the S&P 500 or Russell 3000. To hold much more than this means that the manager seeks to mimic the index itself and become a closet indexer. Once the portfolio holds 100 to 200 names, the research needed to really know the names owned is a Herculean task. Better to own fewer names of companies whose managements you know and whose financials are sound. Keeping it simple is a demanding, yet more proven, time-honored approach, as portfolios can be managed with fewer fees and the comfort of truly knowing the equities at stake.

It is this last principle that gets us back to how we can best reduce risk. It is not by chasing the diversification grail to extremes, holding hundreds of securities. Rather, it is to know the companies you own, thereby reducing the chance of experiencing loss of capital. You and Mr. Buffett will sleep better at night following this path.