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Some Ideas on Risk Management

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As the financial markets are rebounding from last year's rout, it is timely to explore some ways to manage the risks associated with your investments. This is because holding all other variables constant, higher asset prices pose greater risks. Risk management is a complicated topic; "risk" in the investing context means different things to different people. For most people risk involves some vague notion of the possibility of loss, but a precise consensus definition is elusive. We begin this article with a general discussion of risk, and proceed to address how to manage two specific types of risk: permanent loss of capital and price volatility.

Marty Whitman, the late, great value investor, had one of the most intelligent ways of viewing risk. He thought that the word "risk" should not be viewed in isolation, but one should always be precise in defining what type of risk one is talking about. Whitman therefore was careful to use adjectives to describe "risks."

In Whitman's view, many different types of risk exist and are sometimes mutually exclusive. This means avoiding one type of risk would necessarily involve assuming another. For example, the risk of losing purchasing power is one of the most subtle and yet important risks which inflicts those who "safekeep" their money in a bank account to guard against the risk of principal loss. With the eroding effects of inflation and taxes, depositors are in fact generally losing purchasing power over time after taxes and inflation.

Because many different types of risk exist, a simple notion of risk would not adequately capture the complex nature of risk trade-offs. You should be clear about the exact risk being managed. All prudent efforts to address or manage risk will usually require making conscious choices that will exchange one set of risks for another. Having these distinctions clearly in mind will increase the odds of success for investment decisions.

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In this article, we discuss two specific types of risk: permanent loss of capital and price volatility. Permanent capital loss results from diminution in a company's business value on account of deteriorating operations that are likely to persist over time, driving the stock price ***permanently*** below your cost. Price volatility (more precisely negative price volatility) is ***temporary quotational*** paper loss that results from inevitable market fluctuations (aka "market risk."). Below, we discuss some ideas to manage these two types of risk.

Invest with a large "margin of safety"

Investing with a large margin of safety helps mitigate the risk of permanent loss of capital. The margin of safety is a phrase coined by the late, legendary investor, Benjamin Graham, who was former professor and mentor to Warren Buffett. Graham introduced the concept of intrinsic value, which approximates a company's business value. He observed that a company's stock price spends much of the time deviating from this intrinsic value, at least in the short run. Over such short time periods, stock price movements have a very tenuous connection to fundamental business values, with stock prices changing a lot more than the underlying business values. Over longer time periods, the trend of stock prices tends to closely track the direction of underlying business values.

Graham opined that because of this ***price-value convergence*** over time, you can address the risk of permanent capital loss by buying a stock whose price is substantially below the intrinsic value of the underlying business. By buying at a sizable discount, you can potentially avoid permanent capital losses even if subsequent business developments unexpectedly reduce the company's intrinsic value.

This concept is central to what we at PDV and other value-oriented investors look for when evaluating promising investments for purchase. We will buy a stock for clients only if we feel it is selling at a big enough discount to its long-term business value to offer satisfactory prospective returns over time. We try to make the stock price movements our clients' ally. When stock prices are well below the underlying business values, we buy for clients to mitigate the risk of permanent capital loss and capture attractive appreciation potential.

You should be mentally prepared that investing in stocks with a margin of safety is tough on your psyche. When you invest in stocks whose prices are substantially below the underlying companies' business values, you are likely to encounter out-of-favor companies with temporary business problems. Operating issues often can (and do) get worse before they get better. Since nobody has a crystal ball, you will not be able to catch the bottom in the stock price. Worsening consensus sentiment could cause the stock price to continue dropping, creating an even bigger discount (or margin of safety) to intrinsic or fair business value. Such short-term price drops are no cause for concern if you maintain a long-term investment time horizon and the business fundamentals remain intact to justify a turnaround in the company's fortunes. Depending on the circumstances, it may be a good opportunity to buy more.

Another way of looking at the margin of safety is to think of it as an attempt to get more business value at a cheaper price. Mason Hawkins, investment manager at Longleaf, has coined the term "price-to-value" ratio to measure this concept. The lower this ratio, the bigger the discount enjoyed when making an investment, and the larger the long-term return potential as the discount closes over time due to the eventual convergence of price and value. In addition to closing of the discount, benefits may also result from the increase in the business value of the company as it grows over time. As well as playing offense, investing with a margin of safety is playing defense by mitigating the risk of permanent capital loss if the expected business value supporting a higher stock price does not materialize.

With rebounding markets, it is easy to lose pricing discipline and focus. Insisting on a margin of safety before committing new capital and selling overvalued securities are prudent ways to mitigate the risk of permanent capital loss.

Invest in financially strong companies

In our experience, investing in financially weak companies is another common source of permanent loss of capital. Such companies may be forced to take on more debt or look to other external funding sources, such as dilutive equity issuances that are harmful to shareholders. Even worse, if access to financing is limited, a company with insufficient free cash flow may not have the liquidity to stay in business. In bankruptcy, common shareholders may be severely hurt or completely wiped out.

As another way to mitigate the risk of permanent capital loss, look for companies that have high financial strength—low debt levels, good cash flow and plentiful funding sources—that will buy them enough time should operating problems develop. Financial strength also enhances a company's ability to expand its business, withstand economic downturns, and ward off competitors. With robust financial backing, a company further has the flexibility to generate returns to shareholders by paying increasing dividends and/or buying back undervalued shares.

Invest in "low-expectation" companies

Yet another common source of permanent capital loss is overpaying for a popular investment. Typically, an unjustifiably high stock price results from excessive investor optimism reflecting sky-high expectations of a rosy future. To manage this risk, invest instead in companies for which investors' expectations are unduly low. Just as investors can be overly optimistic about a company that is doing well and whose stock has performed strongly in the recent past, investors can also become too pessimistic regarding a company facing temporary setbacks and a lagging stock price. When the stock price already discounts excessively negative sentiment and low expectations, the stock can appreciate simply by beating a low hurdle. When you buy a stock at a bargain price that already discounts the negatives, you have better odds of avoiding permanent capital loss.

Invest with a long-term time horizon

Academic finance measures the risk of an investment as its price volatility relative to a benchmark. To many, this definition of risk has appeal because it captures our natural behavioral tendencies to dislike high volatility (at least downside volatility). Seeing investments gyrate along with the vagaries of the market strains people's emotions and often causes poor investment decisions.

Here at **PDV**, we view this definition of risk as relevant and appropriate for only short-term traders. Buying a high-quality stock at an attractive price might nevertheless be risky for a day-trader whose time horizon is (let's say) only one day; the markets are so irrational and random over the short run that anything can happen over a single day. Buying the same stock to hold for ten years or more makes the same purchase a lot less risky.

A remarkably simple and powerful method to deal with price volatility is to be patient and invest with a long time horizon. This is because market or security volatility diminishes substantially with the passage of time. Market returns over any single calendar year can and do deviate substantially from the long-term average market return. Obviously, security prices during any period shorter than a year (e.g. a single day) will fluctuate even more, often for no good reason at all. Average annualized market returns *over rolling 10-year periods* are much more tightly bunched around the long-term average market return. Price volatility therefore diminishes as your holding period lengthens.

Concluding thoughts

Our natural feelings of fear and greed serve us poorly when it comes to making investment decisions. We tend to be euphoric when prices are high (with attendant elevated risks); conversely we are despondent when prices are low (with muted risks). That is the opposite of buy low, sell high. As the market continues its recovery, it is important that we maintain our risk management discipline. By no means exhaustive, this article has suggested a few ways to manage investment risk.

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