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> ***"Value investing is risk aversion"***
> -Seth Klarman

Risky Business, Or the Business of Risk

The term "risk" gets thrown around every single day in our business. News anchors and national publications report on the findings of analysts and their determinations of risk; everything from fear mongering to cautious optimism to over exuberance and everything in between. Flashy headlines are created by these findings, which can cause one investor to pull their hair out, while allowing another to sleep soundly. This is the business of risk. But, what does risk really mean to most investors? How is it evaluated?

Risk is not necessarily quantifiable or easily represented by a single number or ratio. When evaluating risk, one attempts to incorporate both that which is known, as well as that which is known to be unknown. However, risk also includes a category that is almost impossible to assess -- the **unknown unknowns**; the anvil that falls from the sky, so to speak.

Most of the investment industry today measures risk by using theories that are based on the work of Harry Markowitz, the father of Modern Portfolio Management Theory, who won the Nobel Prize in Economics in 1990. Much of the world of finance subscribes to the Capital Asset Pricing Model, which is based on his work. It is what I studied during my MBA and what continues to be taught in finance classrooms today.

Simply put, in Markowitz's theory, **risk equals volatility**.[1] To elaborate, an investment that exhibits a higher level of volatility in its price is deemed riskier than an investment that shows less volatility.

The term for measuring this volatility is called beta. The greater the beta, the greater the volatility, and thus, the greater the risk. Industry professionals often talk about certain investments being higher or lower beta. The hedge fund industry has generated countless billions of dollars in fees, by claiming to be able to generate above average market returns with lower beta strategies.

But few ask the question: **does this definition of risk really make any sense?**

<u>Do we need "beta" blockers?</u>

To help answer this question, let us explore two potential investments: **Cisco Systems** (which we own) and **Blackberry** (which we do not own).

Cisco Systems, is a global leader in all of its major technology businesses. The company holds $35 billion of net cash, is profitable every year and generates free cash flow of over $9 billion annually. It has a dividend yield of 3%.

Cisco's beta: 1.24*

Blackberry, a once iconic Canadian technology company, is struggling to reinvent itself. The company has been losing money over the past few years and its revenues have fallen some 80% as it tries to adapt and restructure. Its ongoing turnaround strategy has certainly brought its future into question.

Blackberry's beta: 0.85*

*Google Finance, at the time of writing

It appears obvious to us that Blackberry is far riskier than Cisco. However, to many investment professionals, Blackberry is perceived as less risky because its shares have been less volatile over a certain period of time and, therefore, exhibit a lower beta.

Like so many industries, investment professionals and consultants love to use mathematical tools to generate models and measure everything, regardless if there is any real utility for what is derived. To them, if something cannot be measured, then it does not count.

Not everything that counts can be counted

Quantitative theories may be the flavour of the day, however, it is important to look beyond a few metrics and attempt to understand the actual value of what one is buying. Would you buy a used car based on the "blue book" price, without having a mechanic look under the hood?

Volatility is not an appropriate measure of risk, as the example above should illustrate.

Cisco generates stable free cash flow, has many sources of revenue growth and holds a mountain of cash. Blackberry is desperately trying to change its business model in order to survive. How could Cisco be considered riskier? The fact that Cisco's stock price may be more or less volatile today is completely irrelevant to our assessment of risk, especially for owners like us, who are not short-term renters of the stock.

Volatility does not cause us to lose any sleep. In fact, like thrifty shoppers holding out for a sale, value investors actually welcome volatility, as it is precisely that which affords truly great buying opportunities. Given Cisco's huge cash hoard, market leadership and steady cash flow, we view it as a lower risk investment. To us, real risk has little to do with the volatility of a share price and is entirely based on the potential of **permanent loss of capital**.

So why is this important?

We have recently experienced a period of heightened market volatility. The July to September quarter was the worst period for most markets since 2011. Yet, volatility should not cause investors to panic. If a portfolio is comprised of shares in a diversified set of strong businesses, ones that are financially sound, remain profitable, generate excess cash and most importantly, whose share prices remain reasonably valued, then an investor should be able to safely ride out the volatility and use it to their advantage. After all, the stock market can be irrational at times and cause large disconnects between the actual value of a company and its share price. But so long as a company's true worth has not been altered materially, a temporary drop in price should be of little concern.

Investors get into trouble when they own shares of a company whose long-term prospects are in question, be it due to industry or company specific conditions, or weak finances. In weak markets, it is often difficult for these companies to get additional funding, and the risk of bankruptcy and permanent impairment increases.

“Regrets, I’ve had a few…” - Frank Sinatra

When Sinatra sang that line, we could all relate to looking back at some of our mistakes and wishing we had done a few things differently.

Well, I too have had a few regrets.

When I look back at the worst investment mistakes that I have made during my career – a list that includes a retailer, an oil and gas company, a couple of industrial companies and a chemical company – a common theme emerges. While each of these companies offered a significant opportunity for outsized gains at the time, they also shared a common trait: **they had too much debt**. Making mistakes is part of investing, but hopefully one learns from them. After making this same mistake more than once ... I have finally learned my lesson.

At some time or another, every company will experience a rough patch. Regardless of the reason, companies that are financially sound benefit from having time on their side and the resources to weather a storm. Cisco, for example, has so much cash that even if its industry goes through a prolonged downturn, it will be a survivor. It is those companies that do not have staying power that get investors into trouble.

It is easy to get swayed by the potential gains of an investment, without properly evaluating the risks. However, part of being a value investor is learning to focus a lot more on the downside and on what can go wrong. Before we purchase a security, we need to establish that the company has the financial strength to endure a disaster. Think about the financial crisis. When the financial world collapsed, banks stopped lending and many companies that were reliant on financing went bankrupt. Those that were financially sound and generated strong free cash flow not only survived, but were able to take advantage of a depressed market by buying back shares or acquiring assets at a discount.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final Thoughts

Volatility is impossible to escape, but investors can reduce their exposure to real risk by focusing on three important criteria: **quality, price and diversification**.

Despite the allure of striking gold with a leveraged junior mining stock, one is sure to have far better long-term investment results by sticking with quality companies whose shares temporarily fall out of favour.

The price one pays for a security is perhaps the most important consideration. A great company is only a great investment if its share price is cheap enough. In fact, we only look to invest in companies whose share price is trading at a significant discount to its real worth (or intrinsic value). Given the “unknown unknowns,” we need a built-in “margin of safety” in order to help protect against unforeseeable negative events.

The last element that we focus on in order to reduce risk is diversification. We believe in a healthy level of diversification, not just in the number of companies one should own, but also among industries and geographies. No matter how much insight one has or research is done, it is impossible to avoid single stock risk. The recent disclosure that many hedge funds have huge positions in Valeant, underscores a point that should be obvious to all.

There are many wonderful companies in this world and we turn over many rocks in order to identify investment opportunities that meet our selection criteria. That said, if we cannot find enough of those opportunities, then the market is telling us something and we are happy to sit with some cash and patiently wait until the right opportunities present themselves.

There is no mathematical model that can properly quantify risk, and volatility is certainly not a meaningful measure to value investors. Most of us can live with volatility, as long as we are comfortable that we will not experience permanent loss of capital.

If we can avoid large losses, we should end up with good returns over time.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely,

Lorne Steinberg
President

[1] Myles E. Mangram, "A Simplified Perspective of the Markowitz Portfolio Theory", Global Journal of Business Research 7.1 (2013): 59-70. The Institute for Business & Finance Research. Web. 15 Oct. 2015..

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