THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

January 23, 2020, Issue #2

By Nimesh Chandan

What is Risk?

"... But aren't mid caps riskier than large caps?!" the correspondent interviewing me on the channel exclaimed. Her tone was of a person stating a fact rather than asking a question.

I smiled. "Well, that depends on how you define risk"

Ask a security or a portfolio analyst the question: 'what is risk?' And more often than not, you will get the answer – 'Volatility' or some form of it. Some may use the word 'Variance' or 'Standard Deviation'. Academicians have touted volatility as the risk in investing because it signifies unreliability of an investment. Security prices fluctuate and hence an investor may not get the expected return at a time that he/she may want it. Well, this can be a risk an investor faces but certainly not the only risk an investor thinks about. Of the many risks, fluctuating prices is probably the least relevant one.

For seasoned investors, the two most important risks are: a) risk of a permanent loss of capital and b) risk of underperformance to a target or a benchmark. The second one, more important for portfolio managers as it can intensify into risk of losing clients or even career risk. So how did the financial world come to taking volatile prices as a measure of risk?

For seasoned investors, the two most important risks are risk of a permanent loss of capital and risk of underperformance to a target or a benchmark.

'VOLATILITY' AS A RISK PARAMETER

In 1952, Harry Markowitz, an unknown 25-year-old graduate student at the University of Chicago, published a 14-page article titled "Portfolio Selection". The paper was innovative and influential, and later in 1990, earned him a Nobel Prize in Economic Science.

Peter Bernstein recounts the story in his fantastic book, "Against the Gods" (highly recommended read). Young Markowitz had no interest in equity investment when he first turned his attention to the ideas dealt in his research paper. He knew nothing about the stock market and, at that time, was working on a relatively new field of linear programming. One day, while he was waiting to see his professor, he met a stock broker in the waiting room. The broker suggested Markowitz to apply linear programming to problems faced by investors in the stock market.

Instead of gut feeling and crude expression of the concept of risk, investors and academicians could now mathematically express risk.

Markowitz wanted to use the notion of risk along with return to construct portfolio for investors. In his paper, he puts expected return as a desirable thing. And guess what he puts for 'undesirable thing'? Yes! 'Variance'. (Interestingly, throughout his paper there is no mention of the word 'risk' in the investment strategy. He simply identifies it as an 'undesirable thing' that investors try to minimize.) Markovitz did not give any formula for expected return; this is left to the investor to plug in. However, he put a lot of mathematics to show that the most 'undesirable thing' for the investor is the volatile path taken towards attaining that investment return (also known as Variance).

We must give credit to Markowitz for linking risk and return as concepts in investing, because up until 1952, there was no such relationship formally established. Instead of gut feeling and crude expression of the concept of risk, investors and academicians could now mathematically express risk. What followed was everything from risk-return graphs (efficient frontiers) to theories of pricing assets efficiently (Capital Asset Pricing Model). A lot of them won Nobel prizes too.

Many observers, however, feel that selection of volatility as a measure of risk was because of convenience. Howard Marks, a renowned investor, wrote in one of his memos - "it is my view that – knowingly or unknowingly – academicians settled on volatility as a proxy for risk

as a matter of convenience. They needed a number for their calculations, something that is objective and could be ascertained historically and extrapolated into the future."

This reminds me of the "Streetlight" bias – a type of observational bias that occurs when people only search for something where it is easiest to look.

This reminds me of the "Streetlight" bias – a type of observational bias that occurs when people only search for something where it is easiest to look. I am sure you have heard a story about a night policeman who is helping a drunkard search for his lost keys near a street light. After a few minutes the policeman asks, "Are you sure you lost your keys here?" The drunkard says "No. I lost it in the park. But the light is better here."

'VOLATILITY' AS AN OPPORTUNITY

Over the years, the financial theories built on these risk models have come under a lot of criticism. For a long-term investor, volatility is a friend rather than foe.

Benjamin Graham introduces us to an imaginary character called 'Mr. Market'. Imagine you are owning a small share of Rs. 1000 in a business. One of your partners is Mr. Market who comes to you every day, tells you what he thinks the business is worth and also offers to buy your share or offers to sell you his share at his price. Sometimes his valuation is justified by business developments. But many a times, Mr. Market is overwhelmed with enthusiasm or fears and he quotes an absurd number. If you are a sensible investor or a business man, would you let Mr. Market's daily communication determine your value of the business? You would be happy to sell him your share if he quotes a ridiculously high price or buy from him if he gives you an absurdly low price. But rest of the time, you would ignore him.

Daily fluctuations of price or volatility should not disturb the work of assessing the intrinsic value of enterprises.

A true investor is in the same position when he is investing in the stock markets. Daily fluctuations of price or volatility should not disturb the work of assessing the intrinsic value of enterprises. However, an investor can use sharp volatility as an opportunity to buy wisely when prices fall sharply and to sell wisely when prices advance a great deal.

I continued my interview explaining, that in general, prices of mid cap companies tend to be more volatile than large cap companies. But this does not necessarily mean that a portfolio of good and well-managed small sized businesses may not generate better returns than large businesses over a long period of time.

NIMESH CHANDAN
HEAD – INVESTMENTS, EQUITIES
CANARA ROBECO

Nimesh Chandan is Head-Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in his current role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called 'Money and the Mind'.

ABOUT STOIC INVESTOR:

The word "Stoic" is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the "Stoic investor" as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).