

# The View from the Land of **Steady Habits**



## INVESTING IN RISK

A number of years ago, before you could buy tickets in Connecticut for the Powerball lottery, the jackpot for one drawing grew so large that people were driving out of state to buy tickets. People wanted in on a chance to win \$100+ million. Observing this phenomenon, a local newspaper reported the risk/return tradeoff on these ticket-buying trips. It wasn't hard to measure. So many miles on the road translates into a specific risk of injury or death in an accident compared to the one-in-a-hundred-million chance of buying the winning ticket. What was the outcome? These ticket buyers had a greater chance of being killed in a car accident than they had of winning the lottery!

Were the people driving out of state to buy tickets behaving rationally? Is a one-in-a-million chance of dying in an accident worth a one-in-a-hundred-million chance of winning great wealth? Certainly not, unless you love risking your life. But if you are ignorant of the risks, and see before you the prospect—however small—of a life of wealth and leisure, the behavior seems perfectly reasonable.

Life is risky, and rational behavior requires that we know what risks we are incurring, whether it's in driving to the corner without our seat-belt fastened, taking the elevator to our office floor, or consistently eating a high-fat diet. All behavior involves risk. Intelligent behavior seeks to minimize risk exposures, or, at the worst, to accept only calculated risk exposures.

Intelligent investing, however, requires us to behave differently when it comes to risk. Rather than avoiding risk exposure, the intelligent investor seeks it out. Why? Because wealth creation requires the assumption of risk. Capital invested at no risk will not grow. Like the buried talents in the Biblical parable, money not invested does not serve its owner.

Our task as investment managers is to put money at risk. The challenge is to do so wisely. Not all risks are the same, and the risks we seek in intelligent investing are much different from the risks associated with lottery tickets and games of chance. Investment risks are primarily about human behavior, not about the outcomes of random systems. Just because we may put odds on both, we need to understand that the 50/50 chance of getting "heads" on the flip of a fair coin is not the same as the chance of an economic event occurring that experts have judged to be 50/50. The coin flip has a precise random probability, the economic event does not. Economic outcomes depend largely on human actions (and also on natural events like weather), which in turn depend on knowledge, skill, wisdom, judgment, character, and emotion, among other things. And these have no precise probabilities. We must take care not to be fooled by the precisely quantitative appearance of the disciplines we employ in investment analysis: accounting, finance, statistics, or economics. Behind all of the numbers and the mathematics lurks human behavior.

What are the risks we seek? They are the variety of risks associated with putting capital to work in economic enterprises. They fall into three broad categories: owner risk,

lender risk, and insurer risk. If we are not willing to assume any of these risks, we may as well bury our money like the fearful servant in the parable.

Imagine a world in which enterprise managers clearly understand the needs of the marketplace and accurately anticipate the products and services people desired, the most highly valued styles and features of these products and services, and the resources and costs associated with providing them. Imagine further, that in this world, managers formulate good plans to serve markets and are efficient and effective in implementing those plans. In such a world, we could provide equity capital with a high assurance of what the residual returns would be to us as owners, either minority or majority. It wouldn't matter what stage the enterprise is in: start-up, early growth, or mature development. In such a world, if we preferred to be a lender rather than an owner, we could lend money with a high assurance that enterprises would be able to repay the debt as agreed. And in a world of such high assurances, we could also be confident that today's investments would appreciate in value as our enterprises grew and investor confidence was maintained by the universally recognized knowledge, skill, and effectiveness of entrepreneurship.

The real world, of course, is not so clearly understood and managed. Enterprises don't always meet with the success they envision. Market needs are not well understood or properly anticipated. Products and services are not quite what we want. Costs are not as planned. People don't do what is expected. Operations are not as efficient or effective as designed. As a consequence, sales are not as projected. Profits often suffer or even disappear (or never appear!). Lenders are anxious about debt repayments. Owners fear their venture may fail to live up to expectations, or may fail outright. Insurers wonder if the risks are as they estimated. And occasionally, everything turns out better than expected. Sales boom, profits soar, and investors reap rich rewards.

This is the real world in which investors put their capital at risk to create value through enterprise. Aside from weather conditions that can ruin crops and natural disasters that can disrupt markets, by and large, the risk in value creation has its source in human nature, from the limits of our knowledge and understanding to the limits of our abilities.

How do we acquire risk intelligently in such a world? By not putting all of our bets on one type or one source of risk. Don't invest in one company, invest in many. Don't invest in one market, invest in several. Don't invest in just one generic type of risk, invest in several—be an owner, a lender, and an insurer. A good mix of risk exposures will save us from losing our investment if one company fails, if one sector does poorly, if one market goes into recession, or even if returns to owners or lenders or insurers shrink relative to other risk returns. And a good mix enables us to cash in on unexpected positive performance in sectors, markets, or risk categories.

Our primary task as investment managers and trustees is to come up with a good risk mix, to allocate risk exposure in such a way that capital is invested in a wide range of risk exposures, both to capitalize on opportunities and to minimize the chance of loss. As we consider a new asset class for investment, we should ask, "What risk would I be acquiring by investing in this asset class, how have investors been compensated for this risk, how is the risk different from the risk of other classes I already own, and how does this risk balance other risks I already own?"

Portfolio management is risk management, and the expert portfolio manager understands risks, the rewards for assuming different risks, and the similarities and differences among risks. She is like the good steward. She knows that there's a lot more to risk management than calculating the odds of buying a winning lottery ticket, and she's not afraid of assuming risk or the consequences. ■

