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Making “Risk” Relevant – Redux!

Globe-wide, the “real world” bucks and seethes, and daily, Main Street America feels the gnaw of uncertainty. Meanwhile, the US stock market has enjoyed a mostly smooth drift upward since last summer, and is by all appearances carefree as a cat in a flower box.

We hear lip service paid to the notion of risk, but investors on the whole aren’t acting scared. To the contrary, bearishness is very low (15.7% as per the most recent Investors Intelligence polling), implied volatility in S&P 500 index options has been trending down, and excepting a brief dip right after Japan’s disaster hit, the stock market has scarcely hiccupped. The 6-month rolling standard deviation of returns in the US indices is running at less than half its historical median despite the tumult in the headlines, and sits at a level not reached since mid-2007, right before two Bear Stearns hedge funds blew up and became Wall Street’s first major casualties in the financial crisis.

We have some complaints about this relative lack of volatility. Among them: too few instances of good assets being treated badly (we like downside volatility to the extent it makes things cheap enough to deliver fat long-term returns) and too many bad assets being priced as if they were good (just fine to the extent that sometimes new accounts bring low-quality assets we get to sell high, but otherwise irrelevant given our high-quality bias); a likely resumption of moral hazard as the Fed’s “wealth effect” policy of stimulating asset prices to outpace fundamentals encourages speculations that shouldn’t be

undertaken to begin with; the likelihood that low interest rates combined with a specious, statistical calm will invite financial gearing to lever up returns, ultimately destabilizing the overall system via new bubbles which will resolve themselves as bubbles tend to: messily.

In all, what concerns us most is the opposite of what concerns most others. Whereas other investors find market volatility frightening, to us nothing is so dreadful as volatility’s prolonged abeyance.

Because we believe market complacency has an indeterminate shelf-life and artificial forces can’t smooth prices ever upward, this month I’m calling out of retirement an old letter of mine from 2006 (edited slightly) addressing fundamental issues of risk for those who bear its consequences – investors of capital, i.e. you. It counsels that investors shouldn’t let market volatility steer their personal definitions of risk. Formulating the right risk concept ahead of time will steel you when the markets get frantic, as they occasionally do.

Making “Risk” Relevant

For many clients, “risk” is a word that portfolio managers (including yours truly) sometimes toss about too casually, as if expecting our audience to grasp its meaning by the context of what we’re discussing. This can get confusing when we change contexts and suddenly seem to be contradicting the very notions of risk we’d described just moments before. And it doesn’t help when we sprinkle in references to mean-variance optimization, utility functions, or leptokurtosis!

Let’s try some plain talk. Broadly speaking, we can define risk as the chance something might go wrong. But what is the “something” that “might go wrong”? Here we cannot generalize.



To the contrary, what constitutes a risky approach in one instance can be the safe path in another, and vice versa. An investor needing full liquidity at a known amount in one month should regard stocks and bonds as risky, and cash as a refuge. On the other hand, an investor putting aside money for 20 years should seek over time to minimize cash holdings given the likelihood that inflation and taxes will erode their real value over such a long period; a diversified portfolio of stocks and bonds is less likely to “go wrong” when it comes to terminal value two decades hence.

How can it be that in the first instance cash promises safety, and in the second it threatens hazard? How can two fistfuls of dollars have opposite probable outcomes?

Part of the answer is that **risk does not reside in the assets themselves; rather, it resides in how we try to make use of them.** Moreover, the nature of risk changes with the matter of “when” – we cannot isolate risk from time horizon. The late, great Peter Bernstein put it elegantly: “Time transforms risk.”

Popular intuition and professional risk metrics alike tend to focus on the interim volatility of investments (how market values jump about). But a long time horizon can demote volatility to mere distraction or annoyance, something that only becomes a danger if it entices or frightens you into making ill-timed allocation shifts against strategic policy, such that you end up buying high or selling low.

Indeed, volatility itself need not equate risk. Robert H. Jeffrey, who first ran a heavy machinery manufacturing company and then an investment company (and who thus has had that unusual experience of wrestling risk in its tangible as well as its financial manifestations), has put it this way:

“Volatility per se... is simply a benign probability factor that tells nothing about risk until coupled with a consequence.”

I’d prefer to say that volatility is not benign, nor is it malign – rather, at its worst it is an indifferent force, and at its best, a source of opportunity – but Jeffrey still gets right to the meat of the matter. What counts, what makes all of this relevant, is the *consequence* of success or failure in meeting your portfolio’s goals regarding actual liquidity events – those times when you want your portfolio to provide cash for spending or giving, i.e. when it’s time for your wealth to come off the account statement page and into the world. At its most elemental, financial risk – the “something” that can “go wrong” – boils down to this: not having the cash you need when you expected to have it.

Let me sum up by saying this: When you sit down with us to discuss investment policy and portfolio risk, aim first to talk not about assets, but about YOU, or more specifically **what you are trying to accomplish and when you want to accomplish it.** And let’s add a corollary question tying back to Jeffrey’s point about consequence: **what happens if you don’t accomplish what you set out to?**

Until you tackle these questions, discussing particular investments may make for an interesting conversation, but it won’t make for a relevant one.

Defining your portfolio goals vis-à-vis ongoing or eventual uses of cash is hard work. It demands introspection. It demands that you set priorities. Sometimes it demands that you face certain fears. But it simply must be done, because done right it can also unburden you of worry, and free you to pursue what you most want in your life, and what you most want for your family and your community.