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Mitigating Downside Risk

By William G. Knuff, III

Central to the disciplined practice of value style investing and critical to the success of any investor is the notion of mitigating or possibly eliminating downside risk – *i.e.* not losing money. In many respects, this is more important than generating positive returns, and certainly a necessary prerequisite to having any chance at doing so.

Before proceeding, I want to make the point that, although there is some risk associated with volatility, risk and volatility are not the same thing. Wall Street frequently and incorrectly uses these terms interchangeably. Volatility is the short-swing movement of market prices in reaction to short-term supply and demand. Risk is the probability of realizing a permanent loss of capital. Onward.

A smart professional golfer will always try to eliminate one side of the fairway (take it out of play) by playing a safe, high probability shot in order to mitigate the risk of getting into trouble and shooting over par on any given hole. Similarly, a smart investor will always try to eliminate downside risk by relying on a margin of safety ("MOS") to minimize the probability of capital loss. While things can (and do) occasionally go wrong, for the best golfers and investors, this exercise is habitual.

What constitutes a margin of safety in the investment world? Analogous to a bridge engineered to support a 20-ton load with a posted 10-ton limit or a double-hulled oil tanker, an investment that, upon critical evaluation, offers materially asymmetrical risk-return characteristics inherently possesses a margin of safety. Put another way, an investment has a margin of safety if it offers sufficient capital preservation along with potential returns that meaningfully outweigh the potential risks of capital loss to obtain those potential returns.

For example, let's say you had $1 that you wanted to invest and there were two possible public companies in which to invest: Company A and Company B. With Company A, there is a 50% chance of earning a 100% annual return (*i.e.* doubling your money) and a 50% chance of a total capital loss. With Company B, there is a 1/3 chance of earning a 20% annual return, a 1/3 chance of earning no return but preserving capital, and a 1/3 chance of losing 20% of your capital. Viewed another way, Company B offers a 33.3% chance of a partial capital loss. Let's further assume that you could choose to invest your dollar in one company, both companies (in any

proportion), or neither company, opting instead to store it in a Ball jar in your kitchen cabinet. What should you do?

If you thought about doing anything other than reaching for that Ball jar, you might as well head to Las Vegas. The probabilistic (or expected) annual return value of investing with either company is zero…because their risk-return characteristics are symmetrical. Company A offers essentially a double-or-nothing 50/50 gambit, and Company B offers equal chances at a 20% upside or 20% downside. Granted, the expected annual return value of keeping money in a Ball jar happens to be zero too, but there is also no chance you will lose any capital -- purchasing power maybe, but not capital. An uncomfortably high probability of losing capital exists with either company, meaning there is no margin of safety. With Company A in particular, if you had lost all of your capital, you would have had no money left to invest elsewhere…game over. This is gambling, not investing. Never be afraid to hold cash.

Now, suppose you could play again. But this time there is a third company, Company C. Like Company B, Company C offers a chance to earn a 20% annual return and a chance to lose 20% of your capital (*i.e.* a symmetrical return profile). However, with Company C your chance of earning 20% is 95% and your chance of losing 20% is just 5%. Now what should you do?

If you reached for the Ball jar again, this time to retrieve your dollar so you could invest it in Company C, you are learning. The expected return value of investing in Company C is 18% because Company C has an asymmetrical risk profile; in this case, things are skewed heavily in your favor. In the real world, this could be due to any number of factors. For example, the company's stock might be trading well below its tangible book value, net working capital or cash on hand such that, even in a distressed sale situation, your risk of losing capital is far lower than your chance at making a tidy profit.

If you add the possibility of a favorable asymmetrical return profile to a favorable asymmetrical risk profile, and toss in all of the other elements smart investors look for (e.g. good management teams with aligned incentives, effective capital allocation, a history of steady performance, a sound fundamental business, hidden value, etc.), you may have just found a potentially great investment opportunity with a generous MOS.

Along with discipline, patience, critical (sometimes contrarian) thinking, and a dose of humility, this approach can reliably aide investors in mitigating risk and identifying quality investment opportunities. Smart investors do not endeavor to work harder to find investment opportunities or swing at more investment pitches than other types of investors. Rather, we endeavor to work smarter so we can swing harder at fewer, better pitches.