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Defining "Risk"

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A common dictionary definition of risk is "the possibility of suffering injury or loss." In investing, views on the meaning of risk range from versions of this general definition to concepts that suggest risk can easily be quantified for any stock in the market.

In this edition of The FOCUS, *we begin with a review of current textbook viewpoints on assessing the risk of a stock. From there, we explore how these views mesh with what risk means to value investors like us.*

THE TEXTBOOK PERSPECTIVE

A key idea discussed in every Finance 101 course is that, to earn higher returns, investors must take on additional risk. Typically, this lesson begins with the example of Treasury bills. Because of the government guarantee that backs them, the yield offered by these securities is often considered risk-free.

Theoretically, this "risk-free rate" puts a floor under the returns of other securities in the market. If Treasury bills offer a guaranteed yield of 2%, for example, why would anyone buy a share of stock – with no guarantee of payback – if they expected the purchase to return less than 2%? Instead, investors would demand to be compensated for going from the risk-*free* Treasury to the risk*y* stock. Only people who expected the stock to return more than 2% would even consider purchasing it.

But how much more return would the stock have to offer to strike an investor's fancy? This depends on how risky the investor believes the stock to be. And according to textbooks such as *Investment Analysis and Portfolio Management* – one of the CFA Institute-published tomes that all CFA candidates are required to read – there are two main schools of thought on how a stock's risk is assessed.

1. Fundamentals

The first approach links risk to the uncertainties surrounding the stock and the company that issued it. While these uncertainties are varied, they generally stem from six fundamental sources.

Business risk refers to the uncertainty of the firm's income flows and stems from the nature of the company's business. **Financial risk** is the uncertainty created by the extent of the firm's indebtedness and its capital structure. **Liquidity risk** involves the ease with which the company's stock can be sold on the market, and **exchange rate risk** applies when the sale also involves a currency conversion. Finally, **country risk** is uncertainty regarding the political and economic environment of the company's home country, and **global risk** refers to the prospect of international events affecting the livelihood of companies around the world.

Theoretically, risks from these fundamental sources combine to form the aggregate uncertainty facing the stock. And the stock's aggregate uncertainty is equivalent to its overall risk: the higher the uncertainty, the more return an investor would demand from the stock as compensation.

2. Co-movement with the market

An alternative approach to measuring risk comes from modern portfolio theory (MPT), a set of investment ideas pioneered by Nobel laureate academics Harry Markowitz and William Sharpe, among others. A central MPT concept is that a stock's risk is tied to the volatility of its stock price. From this perspective, stocks whose prices fluctuate widely are more risky than stocks whose prices tend to exhibit more stability.

MPT recognizes two factors that influence a stock's volatility: its market risk and its unique risk. Market risk is the portion of the stock's volatility that stems from the market's volatility – in other words, the extent to which the stock and the overall market move together. Unique risk, the remaining portion of the stock's volatility, is driven by the unique features of the stock.

According to MPT, a stock's unique risk is irrelevant because investors can effectively eliminate it by maintaining a diversified portfolio. As a result, MPT's adherents believe a stock's market risk is the only risk that matters – and conveniently, market risk can be measured easily by calculating the stock's beta.

Contrasts between the fundamentals-oriented approach to risk assessment and its beta-centric counterpart include time intensity, objectivity, and precision. A focus on fundamentals requires thorough, subjective analysis of factors such as a company's business strengths and its operating environment. Conversely, the beta of the company's stock can be calculated quickly and impartially. And while the end product of the fundamental approach is often an intangible intuition or a hard-to-describe hunch, a beta calculation can quantify risk all the way down to the basis point, or 1/100th of 1%.

Beta? What's that?

Beta is one output of regression analysis, which is a statistical evaluation of the historical relationship between a stock and the overall market. A beta between 0.0 and 1.0 indicates that the stock has displayed less volatility than the market: on average, if the market moved by 1%, the stock moved by less than 1%. Conversely, a beta greater than 1.0 indicates that the stock has displayed more volatility than the market. In this case, for the average 1% change in the market, the stock's price changed by more than 1%. (A negative beta, which is rare in practice, would indicate that the stock and the market have tended to move in opposite directions.)

Importantly, beta can fluctuate widely depending on the time period and the types of returns under review. For example, an analysis of 5 years of monthly returns could yield a different beta than an analysis of 10 years of quarterly returns.

Dimensions of a Stock's Risk

Fundamentals	Co-movement
business risk	beta
financial risk	
liquidity risk	
exchange rate risk	
country risk	
global risk	

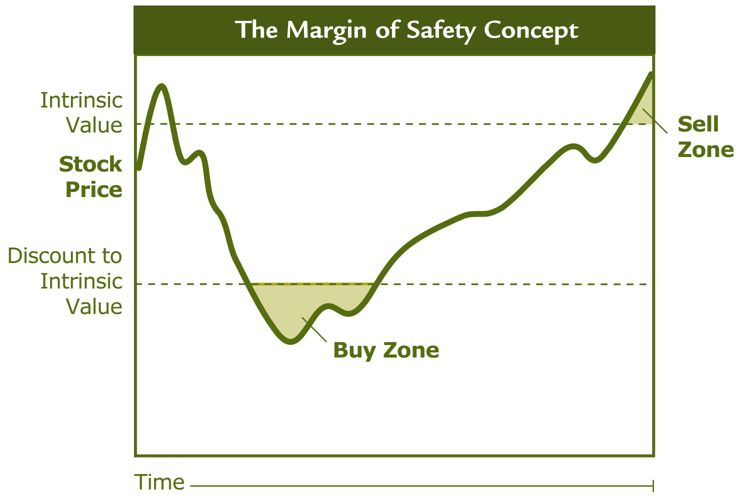
RISK AND VALUE INVESTORS

Warren Buffett – chairman of Berkshire Hathaway, and a protégé of value investing guru Ben Graham – is no fan of theories that equate beta with risk. In his 1993 letter to Berkshire shareholders, Buffett asserts that the beta-based approach to risk assessment "is far off the mark, so much so that it produces absurdities." Instead of beta, Buffett offers a more simple definition of risk. He believes it's whether the after-tax proceeds from an investment "will, over [the investor's] prospective holding period, give him at least as much purchasing power as he had to begin with, plus a modest rate of interest on that initial stake."

Buffett acknowledges that this risk cannot be calculated "with engineering precision." However, when it comes to purchasing businesses, he believes that risk can be judged with a useful degree of accuracy based on factors such as the business's economic characteristics, the quality of its management, and the price of the investment.

Like Warren Buffett, most value investors refrain from equating risk with beta, and instead tend to identify more closely with the fundamentals-based approach to risk assessment. At the same time, the value philosophy's perspective on risk extends beyond fundamentals. At Brandes Investment Partners®, we prefer to think about a stock's risk as a relationship between two factors: its value and its price.

When contemplating the purchase of a company's shares, we ask questions a business owner would be concerned with, such as: "How much income does the company generate?" and "Is the firm on solid financial footing?" We use the answers to estimate the company's intrinsic value, or its net worth. From there, we focus on companies whose market prices offer substantial discounts to their intrinsic values. We see this discount as a "margin of safety" that is inversely related to risk: in our opinion, the larger the margin of safety, the less risky the investment.



Risk in the Portfolio Context

In *The Intelligent Investor,* an investment guidebook he first published in 1949, Ben Graham highlights the margin of safety concept as an investor's first defense against risk. Assuming this margin of safety is present, Graham splits a stock's risk into two remaining components: (1) the risk of having to sell the stock before the market recognizes its intrinsic value, or (2) the risk of a decline in that value. In his words, risk is the chance of a loss "which either is realized through actual sale, or is caused by a significant deterioration in the company's position."

To mitigate the first risk, Graham recommends a long-term perspective, noting investors must be prepared to wait several years for the market to come around. To address the second risk, Graham points to the importance of a diversified portfolio. He acknowledges that any individual company easily can suffer a decline in intrinsic value. "But it is our thesis that a properly executed *group investment* in common stocks does not carry any substantial risk of this sort." (emphasis added)

VOLATILITY: SOME FINAL THOUGHTS

At Brandes Investment Partners, we are wary of investment concepts that equate risk with beta and other volatility-related statistics. For one thing, these numbers are calculated from price movements in the past, while we think risk involves future uncertainty. For another, statistics like beta downplay the relationship between business value and share price, which is the key factor in our investment decisions.

To us, using volatility-related statistics as proxies for risk is – at best – like trying to drive a car while looking in the rearview mirror. At worst, we think it's akin to driving without the benefit of any vision at all.

On a related note, we think volatility might not deserve the bad reputation it's afforded by many stock market observers. We believe short-term fluctuations in the price of a stock often reflect swings in market sentiment, not changes in the true value of the underlying business. These sentiment-driven price moves often create opportunities to purchase stocks at substantial discounts to their true worth – and to sell holdings as their market prices reach their fair values.

In this sense, volatility isn't bad. To the contrary, it's a key contributor to the success of our investment philosophy.

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