What is Risk?

When people seek investment advice, the first response from professionals is usually "How much risk can you take?" The ensuing discussion is then governed by the concept of "risk." In today's financial world, however, the definition of risk used by professional financial planners and stockbrokers has become completely divorced from the definition used by most people.

– Ron Muhlenkamp

MuhlenkampMethods
For the Intelligent Investor
Answers to questions you may not even know you have.

This essay was originally published in Muhlenkamp Memorandum *Issue 11, October 1989. It discusses risk in two categories: the risk of volatility and the risk of losing money. It also discusses long-term investing and diversification as preventive measures to these risks. The 2005 update suggests a third, and often overlooked, risk: paying too much for a stock in the first place. The preventive measure for this is knowing how to value stocks.*

When people seek investment advice, the first response from professionals is usually "How much risk can you take?" The ensuing discussion is then governed by the concept of "risk." In today's financial world, however, the definition of risk used by professional financial planners and stockbrokers has become completely divorced from the definition that most people use.

We believe most people define risk as the possibility of losing money. At Muhlenkamp & Company, we define risk as the probability of losing purchasing power (i.e., money adjusted for inflation). But Wall Street has come to define risk as the volatility in price. By Wall Street's definition, those securities whose prices move the most (up or down) in a short period of time are considered the "riskiest." Those whose prices don't move, like certificates of deposit, are the "safest." We reject this definition of risk. We call price volatility "volatility."

In the late 1960s and early 1970s, when Wall Street and academia started using computers to study patterns in stock prices, they too spoke of volatility, but few people read their articles. So

they began calling volatility “risk,” and more people took notice. Unfortunately, they have gone on to speak of volatility risk as if it were the only risk, and they have built elaborate schemes to limit the volatility of portfolios, often with little or no thought to the underlying assumptions.

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Feature articles in *The Wall Street Journal* on September 19 and 20, 1989, stated that many pension funds are currently investing in real estate. Despite poor returns, pension fund managers are doing so because real estate prices (which are set by appraisals) seem to fluctuate less than stock prices (which are priced every day). These people have convinced themselves that real estate is less “risky” than stocks simply because it is not priced every day.

Expanding Your Horizons

We would like to make several points:

The first consideration in investing is time horizon. Most investors, like most businesspeople, should have a time horizon of at least three years—the minimum time for long-term dynamics to come into play. Pension funds have horizons best measured in decades. For

a pension fund to worry about how much the prices of its assets fluctuated in 1987 makes about as much sense as a farmer worrying about how much his crops grew in February or a ski shop owner worrying about his July sales. For both these businessmen, a year is the minimum period of measurement, and since each can expect two or three poor years in a decade, a three- to five-year period is the more appropriate minimum. The same is true of pension funds.

Pension funds should truly be long-term investors. Yet Wall Street's concentration on the "risk" of volatility has pension funds focusing on *quarterly* returns. (The longest base we have seen for the measurement of volatility is one year.) The real irony is that these same pension funds are overseen by businesspeople who know that in their business the appropriate time frame for measurement is at least three to five years. We have seen any number of astute businesspeople who manage their companies for long-term real growth in value but manage their pension funds by criteria that are short-term and artificial.

For 20 years, we have watched corporate management invest pension funds in a manner that is the opposite of what they were currently doing in managing their companies. They continue to do so today. To improve their corporate returns, many companies are currently selling real estate and buying back stock. Their pension plans are simultaneously doing the

exact opposite (buying real estate and selling stocks). Obviously, they're using different criteria in evaluating these assets. We fail to understand why.

Many people are impressed with the money they make on their houses. They price their houses once every five or 10 years and are perfectly willing to wait six months to get a fair price when selling. Warren Buffett has said he wouldn't care if they closed the stock market for two years. Peter Lynch says the market (i.e., daily prices) is irrelevant to investing. Both individuals have great investment records. So the answer seems to be, if you want to get rid of the "risk" of volatility, don't price your portfolio so often. We don't understand why pension funds are happy with their real estate investments, but not with their company (stock) investments.

A caveat: volatility is a risk. If you had to sell on October 19, 1987, either for financial or psychological reasons, it was a very important risk. But the solution is to not get into a position where you have to sell in a short period of time. Any businessman, whether a farmer or a ski shop owner, who didn't keep enough working capital to get through the slow season would be called a fool. Any investor who invests money needed for groceries in the next few months will soon be called needy.

To succeed as an investor, you must adopt the attitude and time perspective of a businessperson, not that of an hourly employee.

We have seen any number of astute business people who manage their companies for long-term real growth in value but manage their pension funds by criteria that are short-term and artificial.

What we tried to point out in our "Inflation Time Bomb" essay is that the securities whose prices are least volatile in the short term are most likely to cost you purchasing power in the long term. Conversely, those assets that are most likely to enhance your purchasing power long term are often most volatile in price short term. Wall Street's focus on the short term and faulty definition of "risk" lead most people to invest in ways that are counter to their long-term financial goals.

Diversifying for Maximum Return

The second parameter in the discussion of risk is the possibility of losing money. Any investment asset has the possibility of losing money, even though the probability of gain is high. That's the reason for diversification. But this does not mean you should diversify into poor investments.

A financial planner might tell you that if you have stocks, bonds, real estate, mortgages, and commercial paper, you are diversified. But he's looking at pieces of paper, not the companies (and people) behind them. We will tell you that if your real estate is under a Sears store, your mortgage is on the Sears store, your stock is in Sears, your bonds are Sears bonds, and your commercial paper is with Sears, you are not diversified! You simply

have several pieces of paper with the same name on them. And Sears management is working to minimize your return on four of these five pieces of paper. Why would you want management working against you?

We believe you are much more diversified if you invest in good companies in five different industries. Finally, put the management of these companies to work for you instead of against you; own their common stock.

2005 Update

We've just come through a period when Wall Street's definition of risk proved to be a trap. In 1999 and early 2000, many people were caught up in the Wall Street fad centered on Internet, telecom, and technology stocks. Most of the people who "played" these stocks knew they were speculating.

As an offset to this speculation, many invested in "quality growth stocks" (or funds) believing that such stocks were safe because of their low volatility, or low beta. So they felt safe investing in Coca-Cola, Disney, General Electric, and Home Depot. But these stocks, partly because of their reputations, were selling well above their values as companies. Each then had their stocks decline by more than 50%.

The big risk in stock investing is not volatility; it's paying too much for the company or its stock.

To be successful as an investor, you must adopt the attitude and time perspective of a businessman, not that of an hourly employee.

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