WINTER 2011

INVESTMENT OUTLOOK

"Today, basically, on Wall Street, the big money is made by taking risks."
- Bernard Madoff

The Risk - Reward Myth

Too often, due to the fleeting nature of the human attention span and the media's desire to entice us to watch the news or buy newspapers, we are made to think the stock market is a game where we must attempt to buy and sell stocks more profitably than the next person.

Instead, we view our role at Leith Wheeler as stewards of your capital. So the question is not which stock might rise or fall in the next few months, but which businesses do we trust to productively invest your capital over a period of years. A test we put our equity investment ideas through is to ask ourselves if we would want to own the whole business without the opportunity to sell it for 3 to 5 years.

One way we think this investment approach leads to a different result is in the amount of risk we take in our clients' portfolios.

Risk – Reward

When assessing the performance of a portfolio, investors should start by asking the question: "would you rather own Portfolio A that returned 10% or Portfolio B that also returned 10%?" This is not a trick question. Often however, investors only look at return and don't stop to ask a very import question. "How much risk did Portfolio A and B respectively take to achieve those returns?" Obviously, if Portfolio A only took half the risk that Portfolio B took to get the same return, Portfolio A would be the choice of all rational investors.

People, however, have been shown to prefer a gamble where the payout is potentially large and the downside is small, even when the expected outcome is negative. This explains why people play the lottery even though the expected value of a $1 ticket is somewhere around 50 cents. In our view, exclusively owning the shares of high risk companies is not unlike buying lottery tickets.

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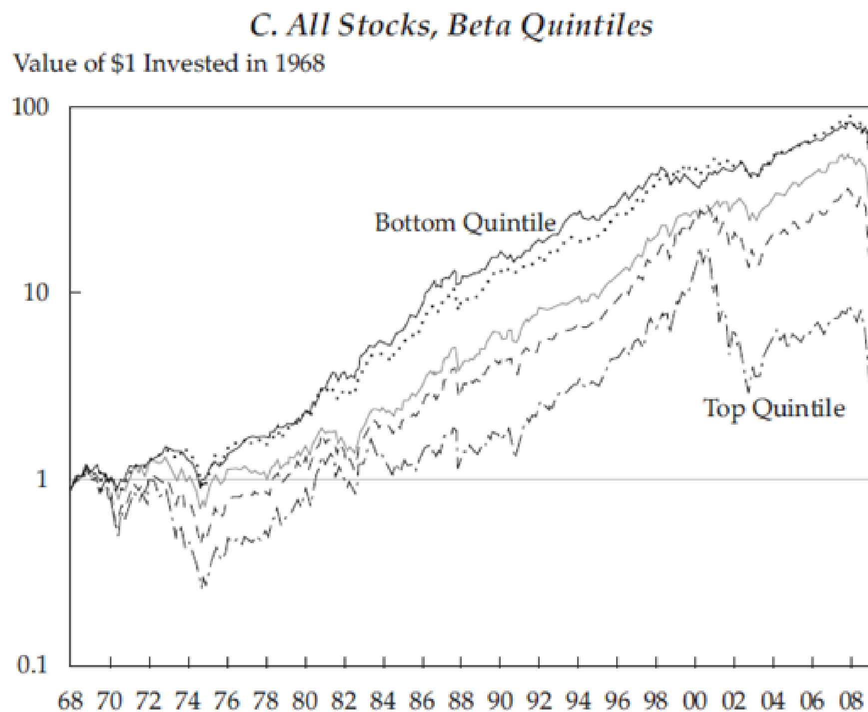
On the other hand, buying steady companies that produce consistent earnings over a 3 year time frame may be less exciting but it does produce less volatile returns.

But which approach yields the better long term track record?

Economic theory has long suggested that in a market where rational participants properly weigh the risk and reward of investment choices, investments will be priced so that taking more risk is, on average, rewarded with higher return. In other words, those that buy high risk stocks should come out ahead despite the jarring losses experienced on many of these stocks. The occasional winner will offset the losses and provide a return that rewards the investor for taking on all those losing stocks. And the investor that chooses the boring portfolio of plodding but steady companies should achieve a lower average return that matches the lower risk they were willing to take.

But the theory may be wrong. A recent study of risk and return in the U.S. market over the past 41 years shows that the least risky stocks significantly outperformed the most risky stocks.[1] The study, led by Harvard's Malcolm Baker, shows that investors appear to be risk seeking and will overpay for lottery tickets and undervalue the steady performers. The results are staggering. The lowest risk stocks in the U.S. outperformed the highest risk stocks by a factor of between 16x and 100x based on two different measures of risk, Beta and Standard Deviation. Looking at just the top 1,000 stocks to eliminate very small companies, the performance of the low risk portfolio led to an ending value that was between 7x and 17x the value of the high risk portfolio.

Returns by Beta Quintile, January 1968—December 2008



The chart above shows that the least risky quintile of stocks, measured by the Beta, grows from $1 to over $60 while $1 invested in the highest risk quintile of stock grew to just $3.77. Beta is a common measure of risk that indicates a portfolio's volatility relative to a benchmark like the TSX Composite. Note that the lines in the chart are plotted on a logarithmic scale (each unit on the vertical axis changes by an exponential increment of 1 off of a base of 10) which dramatically reduces the visual impact of the 16 fold difference in ending wealth.

"Sub-optimal Behaviour" (Getting it Wrong)

The study offered several potential reasons for this anomaly (Academics are loathe to say a long accepted theory is plainly wrong. When evidence contradicts a theory it is called an "anomaly."). All the reasons proposed indicate that investors are just not rational or are constrained in ways that tempt them to act irrationally. To be convinced that investors may not be fully rational watch 10 minutes of "Mad Money" on CNBC.

An example of a constraint that may cause sub-optimal behaviour in pricing risk relates to manager evaluation. Performance measurement against a benchmark may introduce a bias towards higher risk companies simply because these stocks make up a portion of the manager's benchmark. If the benchmark includes high risk stocks and one hits the jackpot, performance will lag if the manager did not own this stock. Managers that underperform lose assets. So for them, holding a higher risk portfolio actually lowers their business risk, assuming their hit rate on high risk investments is in line with the market. If all the risky bets fail, well, they did so for the benchmark too. Meanwhile, managers are rarely congratulated for matching or perhaps lagging the benchmark return slightly while taking significantly lower risk to achieve that result.

Among individual investors and many professionals, there are several failings related to human behaviour that lead us to overprice risky stocks. These include overconfidence, representativeness and the previously mentioned preference for lottery-type outcomes. Representativeness relates to the perception that to achieve great returns a portfolio must include big winners. So the tendency is to believe a portfolio should include the "next Microsoft" which is, of course, nearly impossible to predict. But the pursuit of such low probability outcomes leads to overvaluation of the high risk companies that appear to have the potential to be the big winner of the future.

If risky stocks are relatively overpriced then less risky stocks are by definition relatively underpriced. The outperformance of low risk stocks suggests this to be the case.

The Leith Wheeler Record

Although we don't believe there is a perfect way to measure risk, on several measures, including those used in the Baker study, we have consistently maintained a lower risk portfolio than the market. This is not the product of a conscious effort to manage the risk of the portfolio but the outcome of our bottom-up approach that looks for value in high quality businesses.

Several aspects of our approach to picking stocks get us to this result.

- The discipline to not chase trends or short term fads.
- The ability to remain patient and focused on a longer term investment thesis while ignoring some of the noise that drives short term price changes.
- The focus on investing in companies that have enduring franchises that produce returns in excess of their cost of capital.

And finally there is the price paid. By avoiding fads, looking past short term noise and focusing on an ability to add shareholder value, we buy high quality businesses when they are trading below their intrinsic value. In theory this should not be possible, but as Baker, et al, highlight, investors do systematically underprice these safer, high quality companies. We are grateful for their generosity.

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1: Malcolm Baker, Brendan Bradley, and Jeffrey Wurgler. "Benchmarks as Limits to Arbitrage: Understanding the Low-Volatility Anomaly." *Financial Analysts Journal* 67, no. 1 (January - February 2011).

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