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COULD INVESTING IN “LESS RISKY BUSINESSES” REALLY BE *RISKY BUSINESS*?

By Brandon Snow

The most important concept in investing is that of ***risk***. Without a perception and understanding of *risk,* valuing securities is impossible.

There is no universal definition of risk. However, for our clients, who are trying to compound wealth over time, we think of *risk* as **the probability of a permanent loss of capital and the severity of loss.** Only when the upside potential outweighs the risk of permanent loss of capital do we invest.

There are many sources of risk when investing in a company: competition, supply security, demand changes, cost inflation, key man risk, regulatory and a multitude of others. Financially, risk often comes in two forms: operating risk (income statement and cash flow) and balance sheet risk. Luckily, as bottoms-up investors we can build our models, talk to management teams, project our assumptions for both and get a pretty good handle on what risk means to us through different financial metrics. (Our research process and focus on core businesses help skew this risk to the upside, but I will leave that for another day.)

Risk has certain characteristics that make it extremely hard to define: it changes over time, it is only measurable in hindsight and it is based on perception. It doesn't matter what I think the downside of a stock is because I don’t set the price; what matters is what level of risk the market will reflect in the stock.

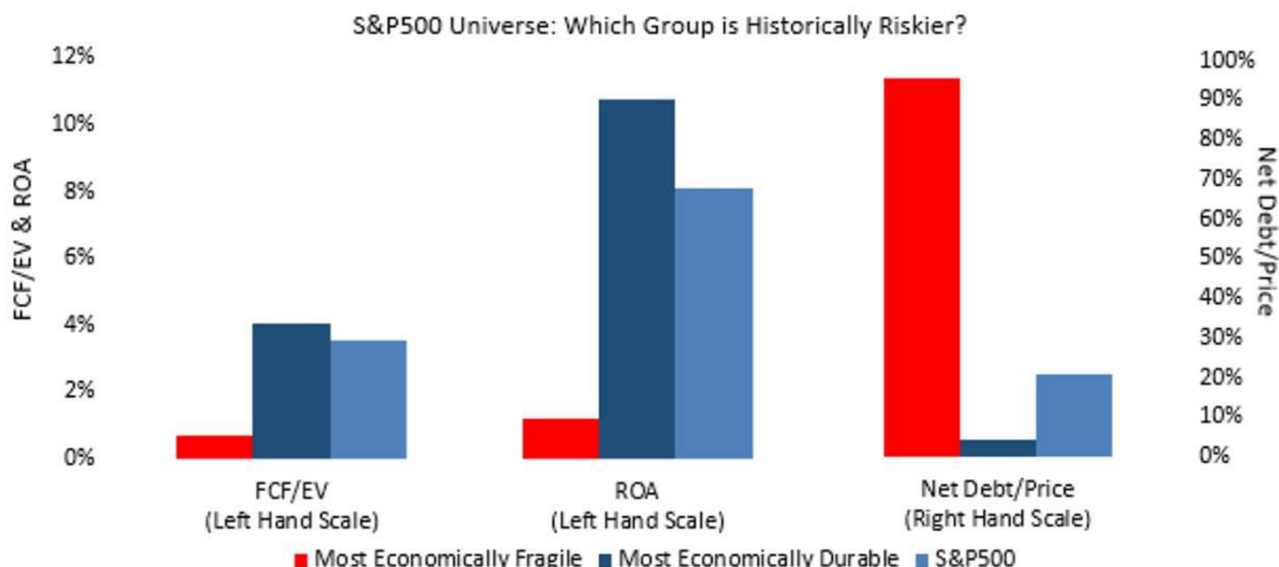
All people, but especially academics, crave certainty, and it is often for the sake of research that assumptions are made to simplify a complex and messy world. *Market theory* is based on the assumption of a "rational person" operating in the market to maximize utility. Based on this assumption, market price fluctuations should bounce around fair value based on a normally distributed curve. This theory works most of the time, but not at the important times. Based on this theory, the 1987 market crash should happen only once in 520 million years.[1]

Since people crave certainty and because market “rules” or “laws” work most of the time, many areas of market theory are based on the normal distribution, including the concept of beta. For those who are unfamiliar, beta measures the volatility of a security relative to the underlying benchmark. As stocks reflect fair value (other than the “noise” around that fair value) and because you can calculate beta, it has become the measure of risk across many financial disciplines. *Modern Portfolio Theory* (MPT), *cost of capital* and *option pricing models* are all based on the concept of beta.

If you haven't noticed from my previous blogs and commentary, I completely disagree with this idea. I am noticing that more and more companies are reducing their required return to pay very high multiples of cash flow for companies, because they think their cost of capital has dropped as markets have gone up and yields have compressed. This will be the source of tremendous value destruction whenever the market cycle turns.

As bottoms-up investors, we use a number of tools to judge the quality, or riskiness, of a potential investment. We focus on the key elements of a business including financial leverage, asset returns and cash generation. Our friends at Kailash Capital follow a very similar approach to their work when looking at the market as a whole.

Recently, they took a look at the S&P500 (ex-financials) through the lens of risk, cutting the constituents into quintiles based on their EBITDA/net debt ratios. Here is how the top and bottom quintiles looked across a variety of metrics:

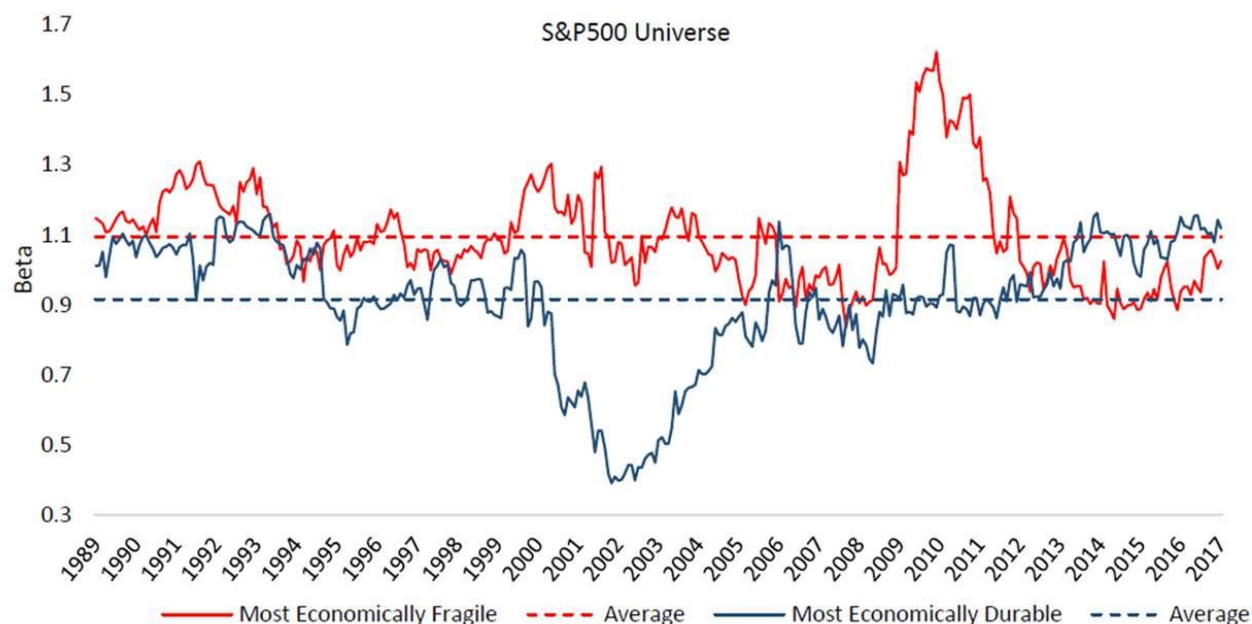


Source: Robert W. Baird & Co Inc, Kailash Capital, Russell, Compustat; Data from 4/30/1989-4/30/2017
Data is ex-financials

Taking a look at the differences, the "most economically durable" companies have superior metrics across returns, leverage and cash generation than the "most economically fragile." Our approach and common sense would suggest the "most economically durable" cohort is less risky than the other.

BUT when you plot the betas of the two groups we can see, for the first time in nearly 30 years, something very strange has happened. Since the beginning of 2013 the fragile businesses have had lower betas than the durable companies:

Fig. 5: S&P 500 Universe: Betas Gone BACKWARD



Source: Robert W. Baird & Co Inc, Kailash Capital, Russell, Compustat; Data from 4/30/1989-4/30/2017
Data is ex-financials

Why would this be the case? It's probably because beta is being used as a proxy for risk, as it is observable and consistent with MPT (which is inconsistent with reality). In fact, it is being used as an input in a variety of products: risk parity funds, volatility-driven ETFs and quant products. Possibly, the movement away from bottoms-up investing to factor-based and passive strategies has created this inefficiency. Maybe people are complacent about risk, after being supported by expanding central bank balance sheets for so many years.

Many concepts work in theory; however, the practical reality is that just because the stock prices of *better quality businesses* move more on a day-to-day basis than *lower quality businesses*, it does not mean that quality has become dangerous, or vice versa.

1. Didier Sornette, *Why Stock Markets Crash: Critical Events in Complex Financial Systems* (Princeton University Press, 2003), 51.

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