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share success

Risk Measures Must Reflect Value

Risk has never been so topical. With many expressions, the concept of risk is rarely applied in a manner which assists investors in acquiring an investment and constructing a portfolio. Risk should protect clients from losses, not unexpected gains, yet most risk measures used say nothing about value. Risk should be viewed from an individual investment perspective and should form an important tool in portfolio construction.

Everyone is now an 'expert' on government bond yields and the movement in spreads over T' Bills or Bunds. Yield is a very useful indicator in bond markets; with all other variables equal, it allows direct comparisons of the credit worthiness of nations and their *relative* risk of default. However, in the *real* world, it is questionable if this provides a meaningful measure of actual risk to investors. Does this mean that UK 10 year gilts are low risk? Risk measures are only relevant when combined with a judgement on value.

The measurement of risk in equity markets is, if anything, more abstract as it is much more difficult to compare like-with-like. It is often expressed in terms of Alpha, Beta, Sharpe Ratios, Standard Deviations etc. These are relative measures and frequently based on historical correlations and offer limited guidance at the time the investment was purchased.

If risk is about protecting clients against losses, there are more practical measures which can be applied in the investment process. From a wealth preservation perspective, the most important tasks for a fund manager are to identify undervalued investments and to construct a portfolio taking account of the risks from the inter-relationship between companies: e.g. are they all dependent on rising commodity prices, dollar earnings or low interest rates?

There are several steps which can be taken to reduce risk: the most important is the concept of Margin of Safety. The best protection against loss is to buy an investment for less than it is worth. The best known exponent of this was Benjamin Graham, who defined it as the discount of the price paid to the intrinsic value of the share. The margin of safety doesn't guarantee a successful investment, however it does provide a cushion against an analyst's judgment.

Share prices are determined by long-term cash earnings. It is, therefore, necessary to look further ahead than most analysts, who tend to try and forecast just the next quarter or next year and are often spoon-fed by the company being analysed. The focus must also be on cash. Ideally investors want businesses that are cash generative and able to fund organic capital expenditure, bolt-on acquisitions and higher dividends. A low risk investor should also prefer to avoid high leverage. Most businesses have sufficient operational leverage through a business cycle to warrant caution but combining this with a stressed balance sheet really raises the stakes.

It is also prudent to take the margin of safety a step further by trying to capture not just the cyclicality of the business, but also how far an estimate of intrinsic value could be from a plausible 'worst case' estimate. In effect, it is important to try and quantify how wrong the estimate could be!

This explicit calculation should be integral in the decision as to whether to invest at all, if the 'worst case' risk is too high. It also helps in determining the weighting in a portfolio. The risk aware investor prefers the comfort of investing in businesses where the worst case has a low probability and still protects capital.

The second strand of protection is in portfolio construction. While risk is often expressed as a deviation from an index, it ignores the inherent qualitative and concentration risks within the index. It is sensible to exclude investments which do not meet acceptable measures of corporate governance, no matter how significant they are in any index.

There is also a risk of concentration in portfolio construction. With almost 40% of dividend payments in the UK coming from just five companies, income portfolios frequently have large positions in these investments. Risk can be managed by limiting the size of investment positions, to say three to four per-cent, depending on valuation and worst case estimates and reduce any holding above say five per-cent of the portfolio, to reduce concentration risk.

The other major portfolio risk relates to factors which drive the performance of individual companies' earnings and the combined inter-relationship of these factors within a portfolio. In a global portfolio of multinational companies, investors should be less concerned with a company's domicile. Within a portfolio, investing in a Greek, Italian, Spanish or French Bank, subsumes many of the same risks. To offset this, strict limits on sector exposure should be maintained, ranging from say 20% for the more homogenous sectors, such as the Financials and Oil & Gas and up to 40% for the more diversified, such as Industrials or Consumer Goods.

Risk is clearly a complex subject and will vary to individual investors and over the investment life cycle. When considered within equity investing it probably still depends on investors taking at least a three year time horizon. Value must be interwoven with the measurement of risk.

Many of the businesses which have a high degree of earnings predictability have historically achieved high earnings valuations, leaving a slim margin of safety. At current share valuations, the balance of risk and value is much more favourable in many instances and offers attractive opportunities for the patient investor.

Graham H Campbell

Chief Executive

Joint Manager of the Saracen Global Income & Growth Fund

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