

THINK DIFFERENT

By

Joe Huber

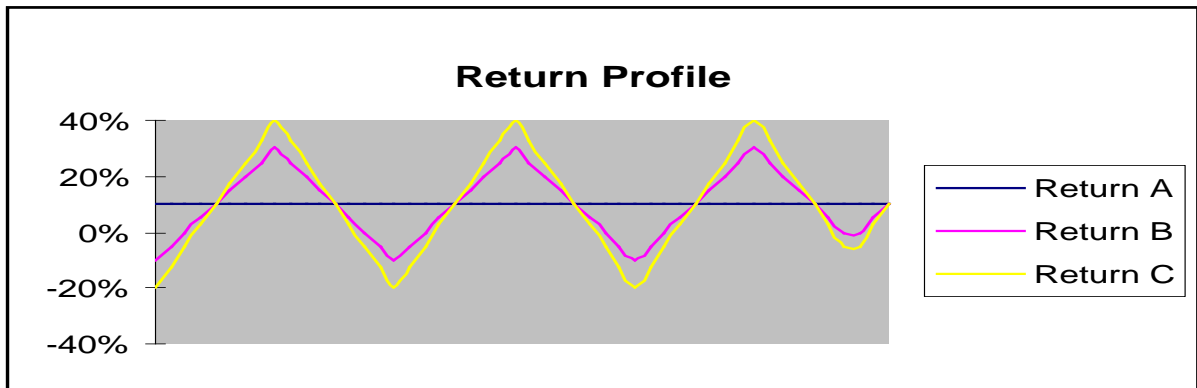
WHAT IS RISK??

Last month my wife asked me how the returns in our house fund were doing. “Not too bad”, I replied. She raised a finger, “You better not lose any of our money.”

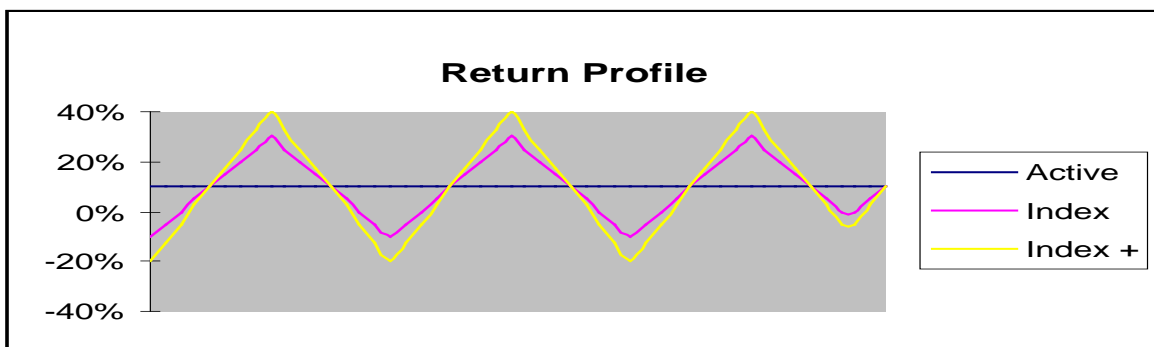
Clearly loss of principal was important to her, and if I cared about our marriage, it should be to me as well. Although well educated, my wife has had little background in finance. What she lacks in knowing about Beta, she more than makes up in common sense: risk is the acceptance of possible capital losses. Even basic finance teaches us that U.S. t-bills are riskless securities and other investments should yield higher returns per unit of risk. While utility theory suggests that the tolerance for risk differs from person to person based primarily on total wealth, what is consistent is that we should demand a higher return per level of undiversifiable risk. In my wife’s case, the first derivative of her utility curve is clearly a large number.

The avoidance of risk is clear in our financial systems. The \$100B insurance market is premised on the avoidance of risk. There are hundreds of trillions of dollars worth of notional derivative contracts outstanding at all times, the vast majority of which are used to hedge away risk.

Consider the following pay-off profile. All three time series profiles yield the same return. Which one should be most appealing? My wife would clearly pick Return Profile A. Why would she accept risk without any incremental change in expected value? The answer is that she shouldn't. Again, her lack of financial academia is overcome by common sense.



Now consider the pay-off profile illustrated below. Again, all three time series profiles yield the same return. My wife would probably look at me strangely and ask, "Aren't these the same pay-offs in the prior example? Why should the answer be any different?" Once again she would be right. The only difference is that this time her lack of financial acumen would lead her to a different answer than many investment professionals.



Over the past two decades, there has been a subtle move to redefine risk as standard deviation about someone-else's (usually an index) portfolio. I have, for a long period of time, attempted to identify the genesis which has led to this type of thinking. I surmise, without any definable proof, that it relates to the same way of thinking that has led in-vogue investment professionals to buy into price/earnings to growth (PEG), and P/B versus ROE regressions, price/eyeballs, and a myriad of other made-up standards of measurement that make neither financial nor intuitive sense. Those who question the lemmings for running off a cliff are ostracized for not keeping up with the times.

I remember having a conversation with my "Big Bank" employer in mid – 1999, trying to explain why we shouldn't have exposure to tech and telecom sectors although they at the time comprised in excess of 50% of the S&P 500 index. I thought I had a bullet proof explanation of why Abby Joseph Cohen and Tom Galvin's view of an undervalued NASDAQ 5000 was wrong. The shot he fired back certainly put a dent in my armor. "You may be right, but if we have no assets left by the time it comes true, nobody is going to be better off." Maybe it was business risk that caused otherwise smart individuals to either knowingly or unknowingly subject their clients to bad investments. Maybe the only way to be in the game is to jump off the cliff. If everybody claims one way is correct, it must be, right? Whether you call it ethics, knowledge, or pure stubbornness, I believe that maximizing risk-adjusted return at the end of the day makes everybody better off, even if there are limited assets to manage.

The fallacy of indexing:

Once upon a time there lived a man named Bogle. He constructed portfolios to mimic those of others (index funds). While he was never in the top decile of performance, he was never in the bottom either. Due to low turnover (trading costs), low fees, and low capital gains (taxes), his investors were able to ever so slightly outperform each year while having a "well diversified" portfolio of stocks. Compounding these slightly higher returns over time led investors to much higher long-term performance than his active brethren.

Now, like every good idea in finance, it only works well until everybody catches on to it. Active managers started to catch on to the passive man and his index strategy. “We can beat him”, they proclaimed. And away they went. They mimicked the indices, and made a few small bets along the way. Somewhere along this time line, professionals became convinced that the indices that Mr. Barra, Mr. Russell, Mr. Standard, and Mr. Poors put together lied on the Markowitz efficient frontier. Index investing became synonymous with low risk (or even no risk). More and more it became important to copy the four horsemen. In 1980, only 11% of active managers had r-squared versus the S&P of over 90%. By 1999 this number was up to 85%. In 1980, going short Nortel Networks meant one of the few hedge funds at the time was shorting the stock. By 1999 it came to mean that one owned only 2.3% of it when it was 2.5% of the S&P 500 index.

The problem with using this type of investing style is that valuation is at best, a secondary component of the thought process. Of more important concern is keeping up with the Jones’. If Lucent’s stock price goes up, we should own more, since it will be a bigger component of Mr. Poor’s portfolio. But buying more will create more demand for the stock (who would possibly want to sell LU at a time when they need to own more in their portfolio?), which invariably causes the stock to go up further, which causes more demand, and so on and so forth. This buy high, sell low strategy would probably seem counterintuitive to my wife, however, to many investment professionals it makes sense. This probably explains why 94% of all large-cap managers owned CSCO in March 2000 at \$90 and only 60% own it today at \$17. It seems that what Mr. Bogle failed to realize is that a price momentum strategy (indexing) only works when there are limited people taking part.

Basic finance textbooks use the S&P 500 index as a risk/reward point on the Markowitz frontier. So why wouldn’t indexing be an optimal risk/reward strategy? The answer is that when price momentum takes over, we lose the “well diversified” definition of the index. Technically speaking, well diversified should mean a set of stocks whose cross-correlation matrix is minimized. Back in the early Vanguard years, this was true. However, as everybody jumped on the low tracking error

bandwagon, it caused the indices to lose much of their diversification properties.

I was born in the 1960s. “In my day”, we didn’t have cable TV, cell phones, computers, VCRs, microwaves, CDs, touch-tone phones, or any of the technology that we now take for granted. All these incredible technological advances were in the early stage of their life-cycles. The technological opportunities must have made investors back then drool like investors look at the internet or 3G today. The only difference is that in 1960, technology and telecom represented only 15% of the S&P 500. In March 2000, they represented a whopping 55%! The S&P 500 is not well diversified. It represents a set of very tightly correlated haves (new economy) and ignores the have-nots (old economy). Mr. Markowitz would roll over in his grave to see that this was being used as his tangial point on his curve! The fallacy of indexing is that when everybody does it, it is not low-risk: it provides a sub-optimal portfolio.

At the end of the day, indexing, or pseudo-indexing (low tracking error) only works when applied in moderation. What always works over the long term is cash flow (even if everybody decides to follow the Huber Capital Management way). Large-cap companies are most often in the late stages of their life cycles. Their businesses are mature, reinvestment opportunities are limited, and cash flow is free. For the majority of these companies, it is important to find management that is less concerned about building an empire, and more concerned about good reinvestment opportunities and returning the rest of the cash to shareholders either through dividends or buybacks.

Low risk should be viewed as low deviation about a mean, not about low deviation around somebody else’s undiversified portfolio. I’m glad to know this, if only to keep my wife happy. Think different.