The Quarterly Report

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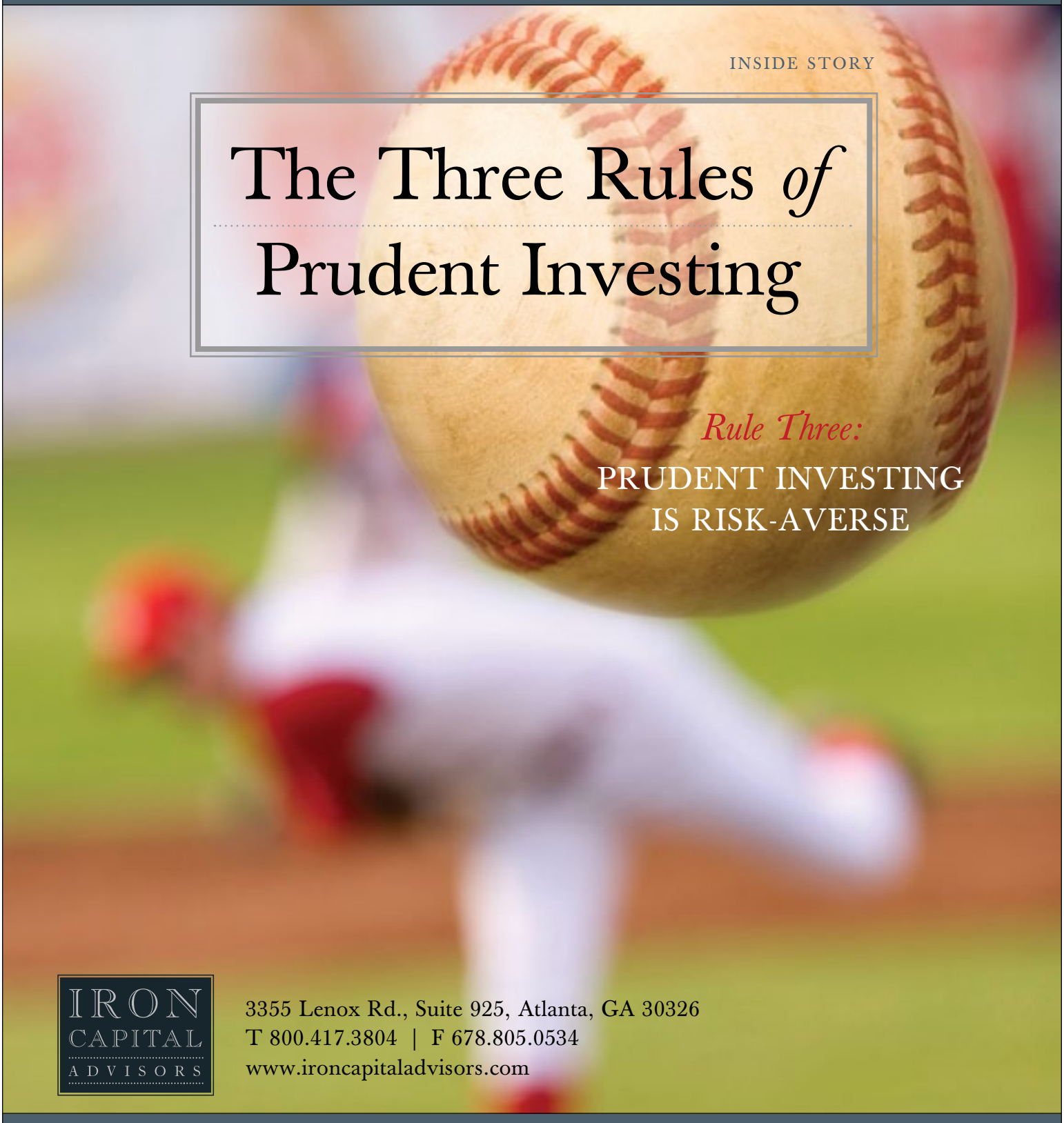

INSIDE STORY

The Three Rules *of* Prudent Investing

Rule Three:

PRUDENT INVESTING IS RISK-AVERSE

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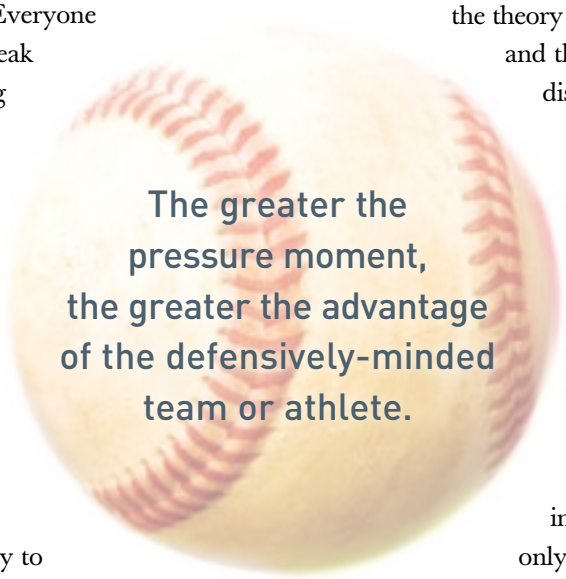
RULE THREE: PRUDENT INVESTING IS RISK-AVERSE

Defense wins championships! I don't care which sport you are playing, the best always understand that defense is what makes the difference when it really counts. Everyone loves the homerun hitters, but come October it is usually the team with the best pitching staff that wins the World Series. Everyone loves scoring touchdowns and watching teams score 50-plus points, but in the BCS National Championship game it is almost always the team with the best defense that wins. Everyone loves the team that can run the fast break and punctuate it with the awe-inspiring slam dunk, but whether it is March Madness or the NBA Finals it is almost always the team that plays the best defense that wins. I could go on and on.

The reason this cliché represents a nearly universal truth is because it is based on the combination of simple math and human psychology. If you hold your opponent to fewer points scored, your offense doesn't have to score that many to win. It isn't a difficult concept to understand. In most sports defense is primarily about attitude and effort, which one should be able to manage with a degree of consistency. Offense, on the other hand, usually requires timing and touch, which can from time to time just disappear even in the most gifted of athletes and especially under the pressure of competition. The excitement of the championship usually makes it easier to "get up" for the moment, have the right attitude and give a full effort. That same excitement, however, often wreaks havoc with timing and touch, leading commentators to often use yet another cliché and explain that the offense just needs to "settle down" and get back to playing their game. The greater the pressure moment, the greater the advantage of the defensively minded team or athlete. Hence the reason for the cliché: Defense really does win when one is under the most pressure – during championships.



The same is true in investing. Defense wins in the end, and in the investing world that means being risk-averse. I know what you are thinking: you are thinking this means having to settle for lower returns, but that is not necessarily the case. Defense can often lead to offense, and I will get to that, but first we need to discuss why people think there is such a strong relationship between risk and return.

This confusion stems from modern portfolio theory. This is the theory that dominates academia, most regulators and the mass educational material that is disseminated from Wall Street. Modern portfolio theory defines risk as beta. Beta is a mathematical term that describes the relationship between the overall market and one particular investment. For those who remember introductory algebra, beta is the slope of the line. What that means is that if the market goes up 10 percent and the investment in question also goes up 10 percent then the beta of that investment is 1. If the investment goes up only 8 percent then its beta 0.8, and if it goes up 12 percent then it has a beta of 1.2 percent.

Any investment that outperforms in an up market by definition will have a high beta, which means that if beta is your definition of risk, then any investment that performs well when the market is up is risky. Conversely, should the market go down and the investment goes down less, it is deemed to have a low beta and therefore labeled safe.

The problems with this definition of risk are manyfold. First, beta is not causal. In other words the investment did not have a higher rate of return because it had a high beta; in fact it is just the opposite. It had a high beta because it had a high rate of return. Secondly, beta is not constant. The beta of an investment is calculated by historical returns, and those return patterns can change at any time. It is probable that an investment that outperforms in the future has a low beta today because most investments, particularly stocks, tend to go along

with fairly flat returns for long periods of time until some positive developments occur and the market realizes that this investment is worth more, and then the price shoots up rather quickly. The opposite can happen as well. The point is that beta changes over time and always reflects things that have already happened, not what might happen in the future, which is what we care about as investors. Beta simply tells us what an investment looked like relative to the overall market in the past. It tells us nothing about the future riskiness of an investment and is therefore a poor measure of risk.

Another common measure of risk is volatility. Technically we call this standard deviation, but the concept is simple: the more an investment's price moves from day to day, the higher the risk. If one uses this definition of risk, then there probably is a relationship between risk and return. The most attractive long-term investments are often companies facing short-term distress. Their prices can swing wildly as little tidbits of news flow regarding the stressful issues at hand. The problem with using volatility as a measure of risk is that volatility goes in both directions. In my experience no client is ever upset by upside volatility; the downside is what people care about.

The other problem is that one is once again defining risk by looking backward, and saying that any investment that had a large return – high volatility = large price movement – is risky. Once again we are defining things as risky after the fact. The level of risk did not determine the return; the return determined what we are calling the level of risk. Just like with beta, it is probable that highly volatile investments were not so volatile before the big move in price. For example: Let's look at bank stocks as an investment. For much of our history bank stocks were considered boring, safe, usually high dividend-paying stocks. This was true right up to the beginning of the financial crisis. These stocks hardly moved unless there was a merger, and many shareholders owned the stocks for years just collecting the steady dividends. In the beginning of 2007 banks stocks had low volatility and low beta; they were labeled safe. Then the financial crisis hit and these stocks took the worst of it right to the bottom in March of 2009. At that point their standard deviations and betas were very high and they were labeled risky. Wachovia's stock fell to $2 before Wells Fargo bought them for $6. Wells Fargo, which trades for $40 today, went down to $7 per share. In March of 2009 the selloff had been overdone and these stocks came bounding back. Since then the volatility has been on the up side. It seems to me that in reality banks were risky in 2007 and safe in March of 2009, but these traditional measures had it the other way around.

I believe there is a better definition of risk. Risk in my opinion is the probability of losing money over a reasonable holding period. What constitutes a reasonable holding period can be in the eye of the beholder, but I would say for an investment it should be three to five years. I like this definition because it is real and constant. Losing money is what real people care about; I have never had a client call me to complain about making too much money. Not once have I had someone say, "Man, this upside volatility is driving me crazy!" When the market goes down, on the other hand, risk becomes important. This leads many people to think that they should alter their risk

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REVIEW *of* ECONOMY

Washington D.C. maybe in the ICU but the real world is in stable condition. Second quarter 2013 GDP came in at 2.5% after first quarter was finally revised down to 1.1%. With the government shut down we may not know what GDP growth is for a while, those who calculate such things were not deemed essential. However all signs are that we remain at a steady sluggish pace of roughly 2% growth. Not good but also not horrible.

The official unemployment rate has dropped to 7.2%. Unfortunately, the biggest part of that drop is from people exiting the workforce. Workforce participation is now the lowest it has been since 1978.

The Federal Reserve Bank (Fed) said "if." All the talk last quarter was of the Fed's impending tapering of quantitative easing. We emphasized that they said they would only do it if the economy was better. It is not and they didn't move in September. Since then, the government has shut down, which makes it even more likely that they will not taper anytime soon. +

REVIEW *of* MARKET

All's well that ends well. After the closest thing we have had to a correction this year, the market came back and finished with another strong quarter. The S&P 500 ended up 5.24%. Small caps were the best place to be ending up 10.21% and now look overvalued to us.

Bonds were flat in the quarter, with the Barclays U.S. Aggregate index up 0.57%. Yields spiked early in the quarter as the talk of tapering dominated the press and then settled back down when no tapering occurred.

International markets came back strongly from being down a quarter ago. The MSCI EAFE was up 11.61% and the MSCI Emerging Markets index was up 5.90%, as Europe exited its recession and returned to economic growth. +

MARKET *forecast*

We remain cautiously optimistic about the equity markets. For the most part, valuations on equities are reasonable, and that cannot be said of almost any other asset at the moment. The smart money will continue to flow into equities.

U.S. large cap stocks still look attractive and International stocks are looking better as well. Emerging markets are perhaps the most attractive on a valuation basis but risk remain. Small company stocks are the only area that appears overvalued.

Bonds remain our biggest concern over the long term. Yields have risen but remain near all-time lows. Stocks may actually be safer. +

» *Continued –*

tolerance with the swings in the market. However, if one understands risk as the probability of losing money, then one will never ask for more risk regardless of what the market is doing. That makes it a better definition and one we can use.

That raises an interesting question: What does it mean to lose money? One might think that is an easy concept, but I can promise you that such a person has never managed someone else's money. Many people think that one has not lost anything until he "realizes" that loss by selling the investment for less than he purchased it. This mentality leads to all sorts of investing mistakes, which could fill an entire newsletter. For now let's just go with a definition of a loss as meaning the current market price is below what we originally paid.

This is important because even prudent investments with a low probability of losing money over three years are going to face short-term fluctuations, and clients do need to be able to withstand those fluctuations. This is why we ask our clients how much they are willing to lose over a twelve month period of time. We often then get asked what the right answer is. I have always refused to answer in the past but since I'm writing this newsletter on risk, I will tell you: The correct answer is approximately 20 percent. Why 20 percent? This is step one of why defense wins championships.

Math! To keep things as simple as possible we will assume a $100 portfolio. If we lose 10 percent, that is $10 so now we have $90. To get back to $100 we need to gain $10, which is an 11 percent return on $90. The gain needed to get back to even is not much greater than the loss. Let's say we lose $20 which would be 20 percent of our original $100. That leaves us with $80 and needing a $20 dollar gain, which is a 25% return, to get back to even. This gain is a little higher percentage than the loss but still in the same ballpark. If we lose $30 or 30 percent, we then need to make $30 from the $70 left, a 42 percent return. If we lose $50 or 50 percent, we then need a 100 percent gain on the $50 remaining to get back to even. All that does is get us back, still not progressing to our ultimate goals. This is why defense wins championships.

As I mentioned there is a psychological advantage in many sports to being defensively minded, and the same is true here as well. Investors make their biggest mistakes when they let emotions control their decisions. After the market goes up they get greedy and tell their advisors that they want to take more risk. When the market goes down they get fearful and in a panic sell everything. Defining risk the way we do leads to the opposite behavior. The probability of loss is largely calculated by what Benjamin Graham called the margin of safety. This was also the title of Seth Klarman's book that inspired this newsletter series. The margin of safety is the difference between what an investment is worth and the price at which it is currently selling. The larger that margin, the less likely one will lose money. Interestingly that is also how one calculates the expected return on an investment. Perhaps the relationship between risk and return is not as simple as we have been led to believe.

At Iron Capital we believe in prudent investing. To be prudent one must select investments from the bottom up, one at a time; one must have an absolute return mentality, largely ignoring the market; and, one must be risk-averse, avoiding meaningful losses of more than 20 percent. Investing prudently takes discipline and patience. Prudence can be out of style for seemingly long periods, but in the end the prudent investors usually win. After all, defense wins championships.

CHUCK OSBORNE
CFA, *Managing Director*