

INVESTMENT PERSPECTIVES

JANUARY 1, 2015

Dealing with Risk

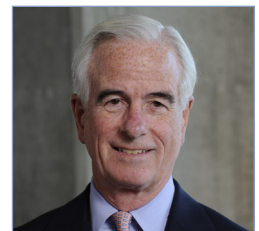
With the exception of a few sudden downdrafts, stocks gained ground in 2014 with relatively low volatility, so now may seem like an odd time to write about risk. On the other hand, it's easier to deal with the subject when the markets are less stressed and investors are more objective. In any event, risk is a critical factor to consider in achieving investment success, and it's important to manage it effectively.

Like beauty, risk means different things to different people, and it presents itself in various ways. We find it's helpful to clients to identify the different forms in order to think rationally about the issue. The first three types are closely related:

- **Risk of loss:** It's probably safe to say that for most investors, the risk of loss is their greatest concern. Loss, in turn, can be thought of as either total loss or, more typically, partial loss of principal.
- **Risk of failing to achieve a specified return:** Similar to the risk of loss is the risk that the return on an investment falls short of projections, even if the return is positive. Since most people expect a certain return on an investment at the time they initiate it, falling short of an ambitious objective on one investment can be almost as painful as incurring a small loss on another, more conservative one. In investing for retirement, lower than expected returns on a portfolio can make a huge difference in one's ability to provide for future living expenses, charitable gifts or the transfer of assets to children.
- **Volatility:** Most academic discussions of risk equate it to volatility, or fluctuation in the value of an asset. And of course, volatility makes most people nervous, especially

during bear markets when fear of loss is heightened. In reality, of course, the loss that matters most is the one that's realized. Unless an asset is ultimately sold at a loss (or less of a profit than expected), the financial aspects of volatility are just, well, academic.

Risk, particularly risk of loss, gives rise to fear or anxiety. Rock climbers, ice climbers and skydivers are often cited as big risk takers, since a miscalculation or false step can have severe "downside" consequences. The first-time climber's reward comes from both conquering new heights and overcoming the anxiety connected with possible failure. As he or she repeats the experience, however, the thrill of success tends to diminish and the risks associated with it may be taken for granted. The notion of repeated success and a resulting false sense of security is something we think about a great deal in environments like the present one, in which risk assets have performed particularly well.



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Senior Advisor

LEANING AGAINST THE WIND

As investment advisors, it's our job to assess the risk involved in various investments and economic environments and counsel clients accordingly. When prices are rising, we try to guard against the complacency that can come from repeated success with high-risk investments. Conversely, when the markets are depressed, we often need to remind clients that risk avoidance

can severely limit returns. Leaning against the prevailing winds is essential to making sure that clients remain committed to well-conceived long-term plans.

Two other types of risk are useful to take into account in managing assets:

- **Lack of liquidity:** An investor whose portfolio has little cash runs the risk of being forced to sell assets at depressed prices when it becomes necessary to raise cash for living expenses, capital calls or any other need. During the financial crisis, a number of large endowment funds with heavy exposure to illiquid alternative assets had little choice but to sell their liquid securities or borrow on unattractive terms in order to fund their spend rates for operations and to meet capital calls on their private equity holdings. Since the markets were severely depressed, the timing of those sales was adverse. We generally advise clients to keep a portion of their assets in cash (what we call our “liquidity bucket”) in an effort to avoid this problem.
- **Concentration:** Investors with a large proportion of their assets in one security run a different kind of risk—namely, that something goes wrong with that particular asset, resulting in a total or partial loss. Even if the concentrated asset performs well, the investor’s sense of risk is typically heightened since the volatility of a single security is generally far greater than that of the market. In other cases, we find that the client’s familiarity with an asset, particularly one he or she has held for a long time, provides a sense of comfort—in some instances, one that is self-deceiving. The old adage, “put all your eggs in one basket and watch it closely,” isn’t practical advice for most investors.

Another way of thinking about risk is to divide it into the components that can most affect the price of an asset.

- **Fundamental risk:** When we consider investing in a particular security or alternative investment, the first thing we examine is what we call the “fundamentals.” With regard to

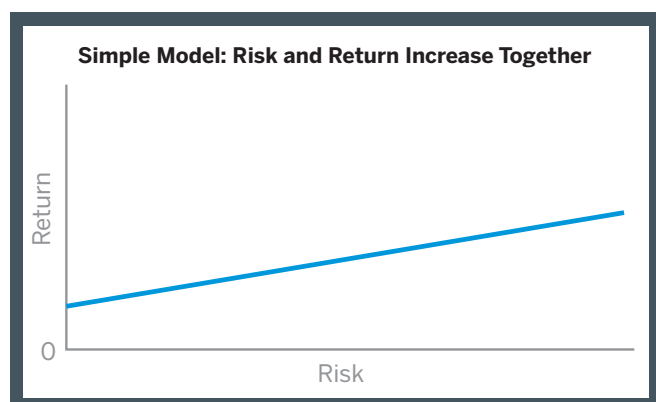
a stock, for example, fundamentals refer to a company’s earnings outlook, competitive position, balance sheet strength, etc. In the process of researching these factors, we assess the probability that a company will achieve our financial projections, which form the primary rationale for investing. This assessment, while not entirely quantifiable, provides a good sense of the fundamental risk of a particular investment.

- **Valuation risk:** Once we’re satisfied with the fundamental underpinning of an asset, we look at its valuation, which can be at least as important in determining ultimate returns. For the most part, the lower the fundamental risk the higher the valuation relative to comparable investments, but such perceptions can lead to disastrous results. We well recall, for example, the favored “Nifty Fifty” stocks (Disney, Xerox, etc.) of the early 1970s. Most of these stocks reached price/earnings ratios in excess of 50x at the market’s peak, reflecting investors’ belief that there was virtually no fundamental risk associated with them. When confidence (and, with it, valuations) declined in the subsequent bear market, it took many years to regain those peak prices despite relatively strong underlying earnings growth. The mistake of paying too much for a security can overwhelm good fundamentals. Conversely, finding a stock whose valuation under-rates a favorable fundamental outlook can lead to high returns.

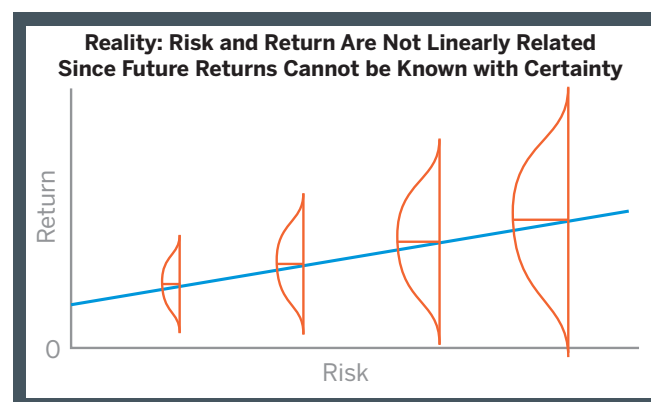
HIGHER RISK/HIGHER RETURN?

In general, the higher the risk associated with an asset, the greater the return expected from it. Yet, as Howard Marks eloquently points out, the relationship between risk and return is not so simple. Howard is the founder of Oaktree Capital Management, a leading alternative asset management firm with a focus on credit, but the ideas he expresses apply to other asset classes as well. His 2011 book, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor*, contains some of his thoughts on risk, which we find similar to our own. He

EXHIBIT 1: Risk and Return—Not a Straight-Line Relationship



Source: Oaktree Capital Management, L.P.



illustrates the conventional view that risk rises in linear fashion with return in the first chart on the previous page. In fact, however, the *future* return on an investment cannot be known with certainty. That is, it's never a single point, but instead a *range* of possible outcomes best illustrated by the bell-shaped curves depicted in the second chart.

The exhibit on the right shows that investors are not automatically rewarded with higher returns when they take more risk. Otherwise, why not simply invest in the highest-risk assets, sit back and enjoy the ride? Instead, each investment should be evaluated in the context of its expected return, allowing for a *range of eventual outcomes*.

Creating a basket of assets, otherwise known as a portfolio, helps narrow the range of expected returns through the effect of averaging. That is, a realized return on one asset that is higher than originally expected can offset one with a lower than anticipated return, so the *average* return of the portfolio has a better chance of ultimately being in line with expectations. Diversification thus helps address concentration risk.

It's important to point out, however, that this averaging effect is more reflective of fundamental risk than valuation risk. Thus, if all investments in a portfolio were to be made at a time when valuations are extreme, the fundamental results might offset one another (i.e., average out) but the valuation risks would still be present in the entire portfolio. In practice, we tend to mitigate valuation risk by averaging into investments over time so as to be deploying capital during both peaks and valleys on the premise that no one is skilled enough to time the markets perfectly. In private equity, for example, we do this by committing to various "vintage years" of venture and buy-out funds.

TODAY'S ENVIRONMENT

In light of the foregoing, what are the major risks we see in today's markets, and how are we positioned to deal with them? This letter isn't suited to deal with security-specific fundamentals, but rest assured that our research team is focused on them. On the other hand, we can make some general comments about the risks we see in the current environment, which in turn have varying degrees of impact on individual sectors and companies.

It's fair to say that the economic recovery in the U.S. is gaining traction, albeit at a slower pace than normal, at least until recently. In light of fragile demand growth, the Federal Reserve seems reluctant to raise interest rates. Rates may move up gradually as the Fed reduces stimulus, but it's unlikely that inflation will rise sufficiently to cause the Fed to induce a recession anytime soon.

Corporate profits are being buoyed by a combination of slack labor markets, a remarkable lack of commodity inflation and low interest rates. Still, the difference in growth between corporate revenue and earnings per share (EPS) is a concern. Average revenue growth for the Standard & Poor's 500 Index was about 4.5% year-over-year through the first nine months of 2014, while EPS increased about 9%. Part of this gap is explained by continuing improvements in profit margins, and

the rest is a function of share repurchase programs, which have added 2.4% to EPS by reducing share counts, according to estimates by Barclay's. The worry is that EPS growth may not be sustainable if interest rates and inflation begin to creep up, pinching margins and making share repurchases less economically advantageous.

While the U.S. remains in recovery, many of its trading partners are suffering from sluggish growth, if not recession. In the third quarter of 2014, Japan entered its sixth recession of the last 20 years. Germany eked out a 0.1% rise in GDP in the September quarter thanks to a rise in private consumption, but its focus on fiscal restraint could throw the economy into recession, along with other parts of Europe. Emerging markets have generally slowed from earlier robust rates of growth, and some, like Russia and Argentina, are in or near crisis mode. To the extent that about a third of U.S. corporate revenue, as measured by the S&P 500 Index, is derived from operations outside the U.S., the weakness in foreign countries poses a challenge for maintaining growth.

We believe that equity valuations reflect the reality of a mixed fundamental picture. Based on projections for 2015 profits, price/earnings multiples are only slightly above their long-term average of about 16 times earnings. Taking into account the low level of interest rates, together with the lack of inflationary pressures, it's hard to argue that valuations are at an extreme.

In short, today's environment strikes us as relatively benign. While the rest of the world copes with sluggish growth, the U.S. economy is slowly expanding, and valuations don't appear to be out of line. It may be, then, that the greatest risk in today's environment is investor complacency. The steady rise in asset values (including equities, bonds and most alternatives) through much of last year has induced a sense of comfort in contrast to the hyper-vigilance typical of more volatile markets. As we saw last fall, however, events can conspire on a moment's notice to remind us that risks are all around us, whether they be geopolitical, social or economic. In times like these, it's helpful to remind ourselves that "risk assets" are called by that term for a reason.

CURRENT POSITIONING

With respect to portfolio positioning in today's markets, in general we are adhering to what might best be termed a "neutral" posture. Clients should be familiar with how we conceptualize portfolios in three categories or "buckets"—*liquidity*, *core* and *opportunistic*. As mentioned earlier, having ample liquidity is critical to avoiding having to sell assets at inopportune times in the market simply to raise cash for living expenses or to meet other needs. We continue to advise clients to replenish this bucket as cash is deployed for various uses, and there's no change in our thinking on this issue.

Reflecting the investment climate, there's also little change in our view of the relative attractiveness of various asset classes in the "core" component of portfolios. While bonds offer meager return potential compared to stocks, they still serve a stabilizing

role, and their returns can be meaningful (up 4 to 7% in 2014, depending on the sector) to a portfolio. Keeping maturities short provides an opportunity to roll over parts of one's bond holdings to capture higher yields as interest rates move up.

In equities, we continue to favor U.S. over non-U.S. stocks, for reasons of the respective economic environments here and abroad. In the U.S., we maintain an overweight to value stocks vs. growth stocks in both large-cap and small-cap portfolios. Value stocks tend to be more conservatively priced, and they have greater exposure to certain sectors, like energy, that have lagged the market in recent times. Outside the U.S., we see better opportunity in emerging markets than developed ones and are overweighted accordingly.

The "opportunistic" bucket is intended to draw attention to a sector or style that we think is especially attractive, at least for a period of time, typically because of valuation dislocations or extremes. Examples include investment-grade corporate bonds in late 2008, or small-cap U.S. stocks coming out of the financial crisis. At this point in the cycle, we don't see exceptional opportunities, largely because pricing among various asset classes seems close to equilibrium; that is, there don't appear to be any particular outliers, with the possible exception of oil and gas plays. We do, however, continue to come across specific managers whose philosophy or approach seems timely and in keeping with our views of the markets, and we seek to bring those to the attention of our clients as we find them.

In closing, we want to take this opportunity to wish all of our readers a healthy and prosperous New Year. [B](#)

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S&P 500 Index represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include: market capitalization, financial viability, liquidity, public float, sector representation, and corporate structure. An index constituent must also be considered a U.S. company. An investor cannot invest directly in an index.

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