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## The Nature of Investment Risk

We are always talking about “risk tolerance” and “risk/reward”, but what exactly are we talking about?

It’s not that complicated. As Sam’s wonderful Irish wife Joan is fond of saying when Sam comes up with some brilliant new idea- *“That sounds nice, dear. Now what’s the worst thing that can happen?”* You too should consider *“What are the bad things that can happen to the companies represented by my corporate stocks, bonds and mutual funds?”*

When you think about it, there are only four “bad things”:

- The company will go broke — bankruptcy risk.
- You won’t be able to trade the security — liquidity risk.
- The company reports lousy earnings and disappoints the market — earnings risk.

- Nothing really happens to the company or its profits, but whispers and rumors run wild and the price plummets— speculative risk.

The first two risks pertain to both stocks and bonds; with the low recovery rates inherent in modern corporate bankruptcies, the only difference is that you are out of pocket sooner with stocks than with bonds. The last two pertain mainly to stocks. In terms of stock selection, liquidity risk can be dismissed for all but the very smallest “pink sheet” stocks, so we are left to consider the question: Just how well does the market price the other three risks?

### **Bankruptcy Risk & Expected Market Return**

In a rational world, distressed companies should have higher returns to compensate for their obviously greater risk. The Fama/French research, the basis for

the classical three-factor model (which uses price/book ratio (P/B) as a measure of distress) seems to bear this out. However it has become obvious that P/B is not a particularly relevant measure of distress in the real world. What happens when we look at more sophisticated measures of company distress which actually have correlated well with future bankruptcy?

It would be reasonable to assume that a portfolio of stocks of these companies that were highly distressed would have high returns. Alas, no: Based on current research high distress correlated negatively with return. To repeat, *the companies at highest risk had the lowest stock market returns.*

### **Earnings Risk**

Over the lifetime of the average investor, most companies will close their doors or get acquired. The only hope of making money is to get dividends and capital



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gains out before it happens. The most worrisome fact is that all companies eventually stop growing, and when they do, their stock price generally stalls or declines. What this points out is that good companies can often be bad investments! What is breathtaking is just how quickly this disenchantment can occur.

In a famous study by Fuller, Huberts, and Levinson (*Journal of Portfolio Management*, Winter 1993), stocks were sorted by price-to-earnings ratio (P/E). The most expensive quintile, as expected, demonstrated spectacular prior earnings growth. How long did this last after they achieved their lofty valuations? As a rule, above average earnings growth persisted for only six years before it reverted to the earnings growth of the rest of the market—about 5% per year. How much extra growth did these stocks demonstrate during this period? About 20%, *total*, over the whole period.

In other words, if a com-

pany was selling at a P/E of 60 in year zero, and its price did not change, at the end of six years it would still be selling at a P/E of 50. But, of course, by that time, its price would have changed, and not for the better. This once again validates our strong preference for value stocks and the mutual funds that focus on them. The most expensive stocks are usually the ones most likely to disappoint.

#### **Speculative Risk**

By now, even the most casual market observers are aware that: when hot glamour stocks have negative earnings surprises, they are taken out and shot, but when staid value stocks disappoint and miss their earning target, the damage is much less.

Conversely, when glamour stocks have positive surprises, they do tolerably well, but when a dog surprises, it generally skyrockets. Can you spell Kmart? So once again, the equity markets do not seem to price a very real risk—

speculative damage—terribly well.

None of the biggest common-sense risks of owning stocks are particularly well priced by the market — not CPA stuff like balance-sheet ratios, but real, definable risks, like a company going under, badly missing its earnings forecast, or simply finding itself as grist from the rumor mill.

No wonder the growth mystique is overpriced and boring old company safety is under-priced. Why, then, aren't mutual fund managers able to take advantage of these obvious inefficiencies?

Several reasons:

- Professors Schleifer and Vishny, pointed out in an article in *Journal of Finance* in 1997 that when mutual fund returns are highest, so are fund flows inward. Unfortunately, this is also true when returns are lowest—just going the other way!
- Even the most successful and disciplined mutual fund managers have rough patches (think about the misery of value fund managers



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in the “dot.com” mania of the late 1990’s) and, to paraphrase an apocryphal Lord Keynes’ saying, the markets can remain irrational far, far, longer than these poor souls can keep their high-paid fund manager job (see point immediately above).

- Most fund managers cannot transact their way out of a paper bag. A strong balance sheet and/or value strategy entails turnover, and unless it’s done with a light touch, fees, spreads, and market impact will wind up swallowing any excess return and then some.

- One of our favorite fund families (Dimensional Fund Advisors-“DFA”) is very good at this and can actually add value through their skill in the high-spread small and micro cap trading arena.

More attention needs to be paid to balance-sheet quality but as the past decade has shown us, a cheap and simple price-to-book sort provides a pretty good way of capturing most of the above

inefficiencies. We’ve come a long way these seven decades since Ben Graham first emphasized the margin of safety in *Security Analysis*. Unfortunately, most of the change has been in the wrong direction.

