Risk Discussion with Howard Marks

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OAKTREE

How To Think About Risk

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Confidential

How To Think About Risk

What is risk?

Risk is the ultimate test of investment skill.

- It’s not hard to achieve investment return.
- That’s especially true when the market rises, which it usually does.
- The real achievement is achieving return with less-than-proportionate risk.

How To Think About Risk

What is risk?

Risk is the ultimate test of investment skill.

- Achieving an above average return with average risk is a significant accomplishment.
- Achieving an average return with below average risk is an equally significant accomplishment, albeit easily overlooked.
  - These managers don't add value:

Market return	+10%	-10%
Portfolio return	+10%	-10%
	+20	-20
	+5	-5
– This one does	+15	-10
– So does this	+10	-5

How To Think About Risk

What is risk?

Risk is an essential consideration in assessing investment performance.

- Return alone tells only part of the story about performance.
- Performance has to be viewed in risk-adjusted terms.
- The key question is "How much risk did the manager bear to get his return?"
  - Was it fair-weather portfolio?
  - How would it have held up if the environment had turned hostile?

How To Think About Risk

What is risk?

Risk is not volatility.

- Academics developing investment theory in the 1960s adopted volatility as their measure of risk. I believe they did this in large part because volatility is readily quantifiable.
- However, few people in the real world consider volatility the key risk.
- Risk premiums aren't demanded in response to volatility.
- **Volatility can be an indicator of the presence of risk – a symptom – but it is not risk itself.**

How To Think About Risk

What is risk?

Risk is the probability of losing money.

- This is what most people mean when they say “risk.”
- This is what people demand compensation for if they are to bear it.

How To Think About Risk

What is risk?

Risk is the probability of missing out.

- Opportunities forgone represent a serious performance shortcoming.
- Thus the risk of missing opportunities is another important risk.

How To Think About Risk

What is risk?

Risk is the likelihood of being forced out at the bottom.

- Many investors claim to be long-term oriented and thus immune to fluctuations.
- But bad-enough declines can make them sell:
  - because they lose confidence,
  - because they receive margin calls or
  - because of a need to fund real-world cash requirements.
- Some of the greatest pain in 2008 was felt by investors who had overestimated their ability to withstand volatility.

Selling at the bottom – turning a downward fluctuation into a permanent loss and missing out on the subsequent rebound – is <u>the</u> cardinal sin in investing.

How To Think About Risk

Where does risk come from?

> **"Essentially risk says we don't know what's going to happen. . . . We walk every moment into the unknown.**
>
> There's a range of outcomes, and we don't know where [the actual outcome is] going to fall within the range. Often we don't know what the range is."
>
> – Peter Bernstein

How To Think About Risk

How should risk be considered?

I. “Risk means more things can happen than will happen.”

– Elroy Dimson

How To Think About Risk

How should risk be considered?

II. The future should be viewed not as a fixed outcome that's destined to happen and capable of being predicted, but as a range of possibilities and – hopefully on the basis of insight into their respective likelihoods – as a probability distribution.

How To Think About Risk

How should risk be considered?

III. Knowing the probabilities doesn't mean you know what's going to happen.

"We live in the sample, not the universe."

– Chris Geczy, Wharton School

On Super Bowl morning in February 2016, here's what a commentator said:

"Carolina wins eight times out of ten. This could be one of the two."

How To Think About Risk

How should risk be considered?

IV. To invert Dimson's comment, even though many things can happen, only one will.

Thus the "expected value" – the probability-weighted average of the possible outcomes – can be irrelevant.

Oftentimes the expected value is not among the possibilities.

Even worse, the concept of the expected can be misleading and dangerous.

A high expected value can lure investors into propositions with downside possibilities that can't be withstood.

How To Think About Risk

How should risk be considered?

Risk is hidden and thus deceptive.

- Loss is what happens when risk – the potential for loss – collides with negative events.
- Even if it contains construction flaws, a house will stand until there's an earthquake.
- Equally, an investment can be risky and still not show losses as long as the environment remains salutary.
- The fact that an investment is susceptible to a serious risk that will occur only infrequently – the "improbable disaster" or "black swan" – can make it appear safer than it really is.
- **The riskiness of an investment doesn't become apparent until the investment is tested:**

"It's only when the tide goes out that we find out who's been swimming naked. "

– Warren Buffett

How To Think About Risk

How should risk be considered?

Risk is not a function of asset quality alone.

- **A high-quality asset can be priced so high that it's risky.**

How To Think About Risk

How should risk be considered?

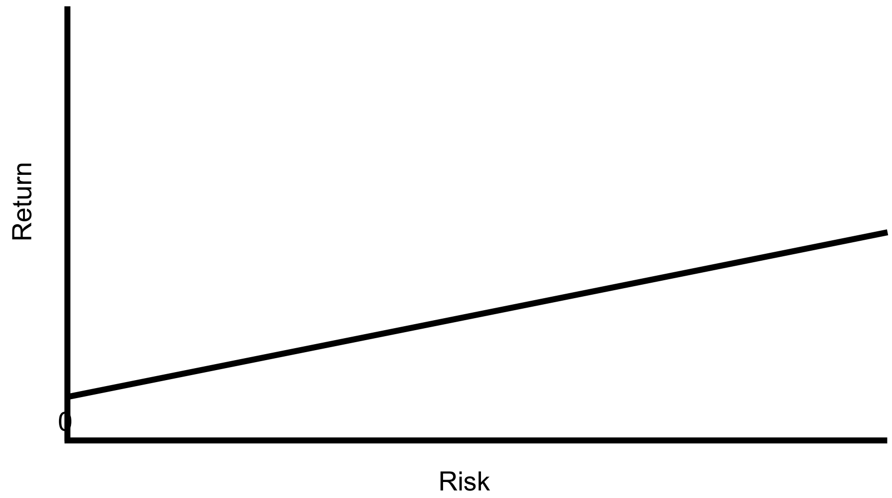
Risk is largely a matter of price.

- **A low-quality asset can be cheap enough to be safe.**

How To Think About Risk

What is the relationship between risk and return?

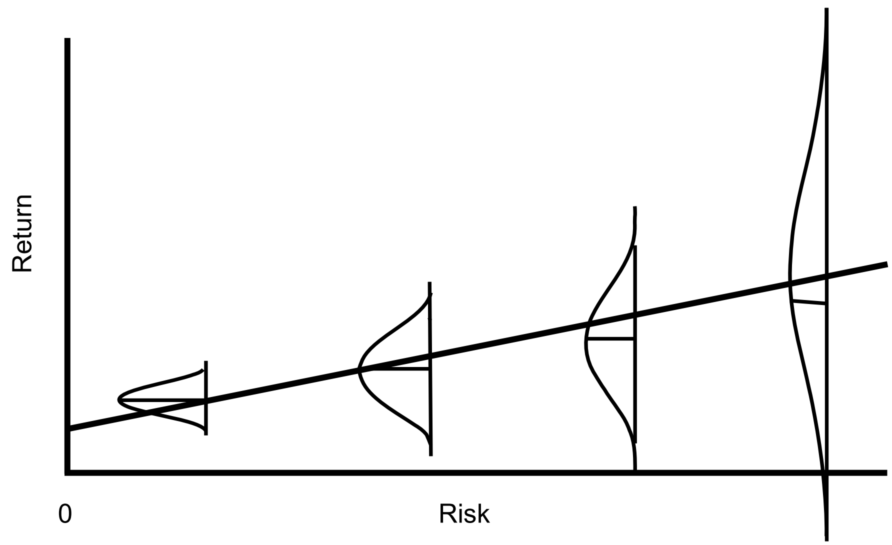
- Most people suspect there's a relationship between risk and return.



- They may say, "riskier assets produce higher returns" or "the way to make more money is to take more risk." These are traps into which most investors fall, especially in times when things are going well and risk taking is being rewarded.
- **If risky investments could be counted on to produce high returns, they wouldn't be risky.**
- Rather, it make sense that investments that seem riskier must appear to offer higher returns in order to attract capital. But they don't have to deliver.

How To Think About Risk

What is the relationship between risk and return?



- As risk increases,
  - the expected return rises,
  - the range of possible outcomes becomes wider, and
  - the worst outcome worsens and ultimately becomes negative.

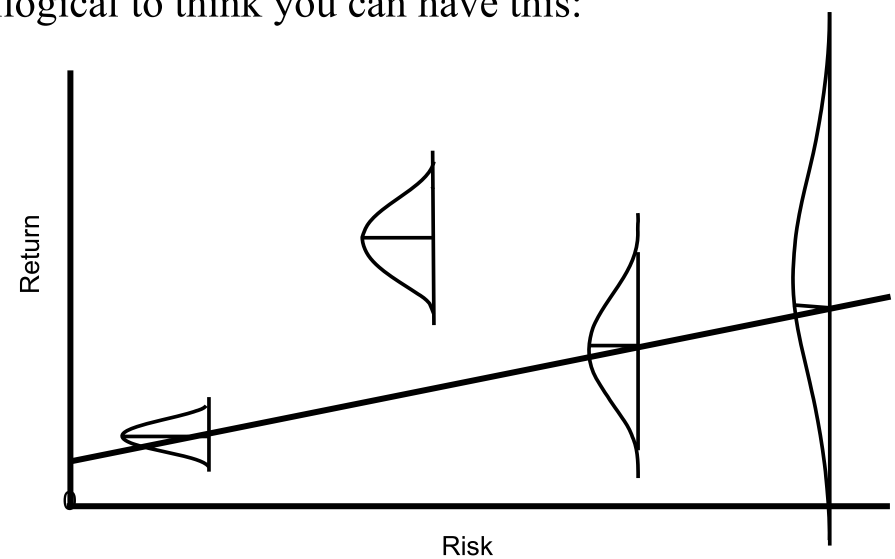
This is the right way to think about the risk/return relationship.

How To Think About Risk

What is the relationship between risk and return?

In a market that is at all efficient, the chance for substantial gains can only be part of a range of possible outcomes, some of which are undesirable.

So, for example, it’s illogical to think you can have this:



In fact, when people conclude they have this “free lunch,” they usually engage in behavior that underestimates the risks.

How To Think About Risk

How should risk be handled?

What determines investment success?

Investment performance is a lot like pulling one ticket (the outcome) from a bowlful of tickets (the possible outcomes).

The outcome that occurs never amounts to anything but one ticket picked from among many.

Superior investors have a better sense for the tickets in the bowl, and thus for whether it's worth participating in the lottery. That's what makes them superior.

They still don't know for sure what's going to happen, but their "better sense" enables them to do a better job of dealing with uncertainty.

How To Think About Risk

How should risk be handled?

The essence of risk management:

> "Because of the existence of risk, things are going to be different from what we expect from time to time. How well are we prepared to deal when it's different?"
>
> – Peter Bernstein

How To Think About Risk

How should risk be handled?

According to Peter Bernstein, risk just means things are uncertain: "good things can happen as well as bad things."

But I think the definition of risk should emphasize the notion of results you don't want.

Thus I'd say **risk is the possibility that from the range of uncertain outcomes, an undesirable one will materialize.**

- It can consist of suffering a permanent loss of capital when bad things happen.
- It can also consist of missing out on gains when good things happen.

How To Think About Risk

How should risk be handled?

Let’s say you think that if you buy something today, there’s a 1/3 chance it’ll be down in 6-12 months.

What do you do about that risk?

How To Think About Risk

How should risk be handled?

Let’s say you think that if you buy something today, there’s a 1/3 chance it’ll be down in 6-12 months.

What do you do about that risk?

And what do you do about the other 2/3?

How To Think About Risk

How should risk be handled?

Risk is capable of being borne intelligently.

You can bear risk prudently and profitably if it is:

- **risk you're aware of,**
- **risk that can be analyzed,**
- **risk that can be diversified, and**
- **risk you're well paid to bear.**

How To Think About Risk

How should risk be handled?

Risk is kept under control in superior portfolios.

- **Highly skilled investors assemble portfolios that will produce good returns if things go well and resist decline if things go poorly.**
- **This asymmetry is the critical element – in my opinion, the cornerstone – of superior investing.**
- **Assembling a portfolio that incorporates risk control along with the potential for gains is a great accomplishment. But it's a hidden accomplishment most of the time, since risk only turns into loss occasionally . . . when the tide goes out.**

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