Risk, Reward and Resiliency

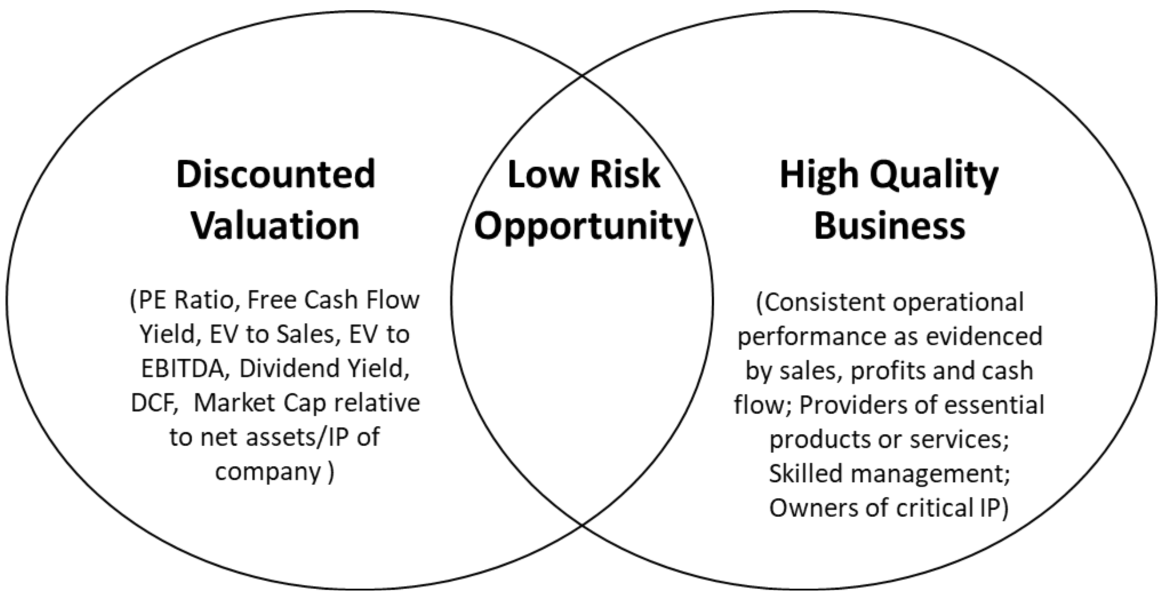
A lot can happen in a year. Over the last 12 months we have endured a pandemic, social unrest, heightened political tensions and an economic collapse and recovery. If you are feeling exhausted, you are not alone. Any one of these events would have been difficult to navigate, let alone all of them in succession. The stress of the last year proved combustible for both society and financial markets. Still, a year later, life goes on and, despite recent volatility, markets have staged a historic rally. There are many lessons investors can learn from how the last year's events unfolded, but the key one is to expect the unexpected.

Just as in life, there is no such thing as a sure bet in financial markets. All investments – from U.S. government bonds to blue chip stocks – contain an element of risk. Even an asset as safe as cash is subject to the risk of inflation. While you can't escape risk as an investor, properly analyzing it can improve the resilience of your portfolio in the face of the unknown.

There are numerous definitions of risk in finance, with most relating to the volatility of an underlying stock or bond, or basket of securities. Essentially these definitions boil down to the more extreme a security's price movements, the higher that security's risk profile. While the volatility-based definitions of risk can be expressed in straightforward mathematical terms and are logically sound (after all, higher volatility increases the likelihood that a stock or bond's price will fall), we think a better way to conceptualize risk for most individual investors is the chance of permanently losing capital over your intended holding period. The lower you can drive down the risk of permanent loss, the sturdier your portfolio should behave during periods of stress.

You may have heard before that to achieve outsized returns you need to take outsized risks by investing in highly valued, volatile or speculative securities. The positive correlation between risk and return is a popular financial theory, but we don't think the conclusion matches real world experience. Rather than ramp up one's risk profile to achieve outsized gains, we believe that to outperform over time one must seek to minimize risk by investing in assets where the chance of permanently losing capital is small relative to potential return prospects. For stock investors, this means investing in companies whose valuations are <u>undeservingly</u> low based on the quality of the underlying business and therefore largely discount the possibility of negative outcomes.

<u>The Low Risk Sweet Spot</u>



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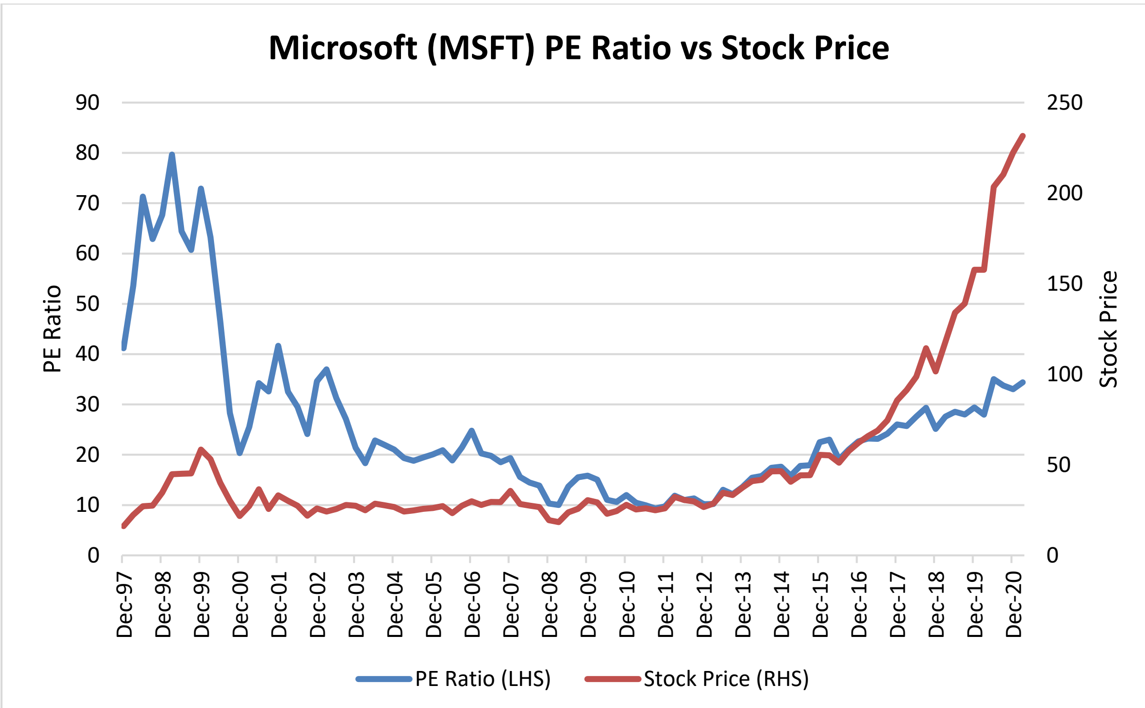
This may sound repetitive based on the message from many of our letters, but the starting valuation you initiate a new position at really matters for both your portfolio risk management and future return prospects. To revisit our frequently used Microsoft example, buying the stock at 80x earnings in 1999 worked out terribly compared to investors who bought the stock at a price to earnings ratio under 20 during the subsequent 16 years. This is the case even though Microsoft was a high-quality firm in 1999 and continued to operate well over the ensuing decade, producing growing sales, cash flows and earnings.[1]



The lower the valuation you can buy into quality businesses, the less likely you are to suffer material downturns during inevitable bouts of market volatility and the more likely you are to experience meaningful gains as valuations eventually improve. Discipline when it comes to valuation may seem difficult in market environments like ones during the last year where substantial fiscal and monetary support provided a major lift to high-risk assets. For example, a Goldman Sachs proprietary index of non-profitable technology firms returned nearly 435% from the March 2020 lows through early February this year. During the past several weeks of increased volatility (driven largely by the rise in interest rates), that index is down close to 25%. Compare this to steadier businesses such as vastly lower valued (and admittedly slower growing) aerospace and defense firms that were up only 54% from the March 2020 lows through early February, but over the last few weeks have appreciated another 2.2%.

This isn't an argument to avoid growth stocks at early stages of their business evolution. In many cases, we like investing in such firms (particularly in companies on the cutting edge of technology and biotechnology), provided valuations are compelling. Buying early-stage technology companies during March last year worked out terrifically as valuations largely reflected close-to-worst case scenarios of the firms going out of business. In retrospect, these technology firms were largely de-risked at their year-ago prices. With the tailwinds of government stimulus, low interest rates and an improving economy, the share prices eventually exploded upwards. However, buyers of such stocks a month ago at extreme valuations that priced in years ahead of rapid growth rates may face similar remorse as Microsoft buyers at the peak of the technology bubble. Rather than earning outsized compensation for taking on outsized risk, many new early-stage technology investors may suffer lengthy or permanent capital losses.

The point of our letter, again, is that entry point valuations and underlying business quality matter. What makes life sometimes challenging for investors is that valuations fluctuate over time, sometimes wildly. As quality tends to be a more stable feature, we think investors can do best over the long-term when first focusing on companies with high quality attributes and then determining which of those firms have compelling valuations. While there is no one catch-all that defines a quality firm, we think key indicators include:

- Consistent operational performance as evidenced by stable or growing sales, free cash flow, profitability and margins.
- Companies that provide critical products or services.
- Skilled and/or experienced management teams.
- Owners of valuable and difficult to replicate intellectual property.
- Strong execution into a large total addressable market, or underserved market, opportunity.
- High brand awareness and/or growing brand traction.

If you can buy companies displaying one or more of these attributes at valuations that don't reflect the underlying business strength, you can lower your risk profile and improve your chances of weathering unexpected market stress events. Additionally, you can likely improve your future return prospects: though in the short run markets may inefficiently value companies for various reasons, over the long run valuations tend to fairly reflect business fundamentals.

The last piece of the puzzle, and perhaps the hardest, is determining what is a high or low valuation. This a subject worthy of a separate and thorough analysis, but in brief here are a few things we look at:

- Valuations relative to similarly situated peer companies, firms in the same industry or sector and/or the rest of the market.
  - Valuations can be assessed based on price to earnings, enterprise value[2] (EV) to sales; EV to EBITDA[3], free cash flow yield[4] or dividend yield to name a few.
- Reviewing what similarly situated companies have sold for in recent M&A deals.
- Determining the value of a company's assets or intellectual property.
- Conducting a discounted cash flow analysis that seeks to determine the present value of a company's future cash flows.

There are strengths and weaknesses to all these methods. For example, if you are comparing a company's value to its peers and its peers are all wildly overvalued, then the fact it is trading at a discount to those other firms doesn't tell you much. Also, if one thinks that the low interest rate environment of the last ten years may be shifting to a higher rate regime, then you could make the argument that the market as a whole is expensive and specifically that most growth stocks are overvalued relative to value and cyclical firms (investors seems to be making this wager over the last month). While experience helps, there are many nuances to approaching valuation and it's just as much an art as is determining a company's quality. The key is to have a consistent and disciplined approach.

High quality businesses trading at compelling valuations are hard to come by, which is a reason we are not very active stock traders. When we are confident that we have found a low risk opportunity, we are patient for the company's stock performance to improve and tend to like holding onto the position for years to let returns compound from an attractive entry point. Buying high quality companies at low valuations not only should help de-risk your portfolio and improve your future return prospects, but perhaps most importantly should provide some peace of mind during periods of heightened market volatility. If you have confidence in what you own and understand why you own it, you should hopefully be able to better withstand the psychological stress that comes with periods of heightened and unexpected market turmoil.

A portfolio constructed with the unexpected in mind is likely to look and perform much differently than one predicated on extrapolating today's popular trends into perpetuity. The former strategy is value and risk sensitive, whereas the latter is really just a momentum strategy. There is nothing wrong with a momentum strategy, but one should have an appreciation for the risks it entails: when momentum shifts, such strategies tend to severely underperform unless an investor is quick to reposition his or her portfolio. The reason we think value and quality are such important bedrocks of portfolio management is that no one can predict the future with certainty. While good investors should have educated guesses about what the future entails and structure their portfolios to capitalize on evolving trends, the long game is one of survival. Making sure that our hard-earned capital can serve us into the future requires mitigating risks along the way instead of seeking to ride along with the current hottest trends. A value and quality based approach can sometimes be slow and frustrating – especially during periods of heightened valuations where attractive opportunities are limited. All things considered, though, we think it is the best approach to limit risk, increase potential reward and improve portfolio resiliency during future unexpected events.

Please let us know if you would like to discuss your portfolio, your current approach to risk management and current ideas we have that we think fit into the value and quality framework. We hope you and your families are doing well and staying safe.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

Citations and Disclosures

[1] Bloomberg (all financial data cited herein is sourced from Bloomberg unless otherwise noted).
[2] Enterprise Value is equal to a company's market cap *plus* debt *minus* cash.
[3] EBITDA means Earnings before interest, taxes, depreciation and amortization.
[4] Free cash flow yield is equal to a company's excess cash from operations after making business investments *divided by* the company's market cap.

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