Risk

TANDEM INVESTMENT ADVISORS®

COMMENTARY – OCTOBER 2019

What is risk? It's subjective, really, isn't it? An *"in the eye of the beholder"* sort of thing. Perhaps Justice Potter Stewart's opinion on obscenity best describes our understanding of risk – *"I know it when I see it."* But do we?

To most, risk is only vaguely quantifiable. It is either present in some degree, or it isn't. Others think of risk in terms of a probability or likelihood – *I know I shouldn't move this heavy piece of glass by myself, but I can probably manage.*

Peter L. Bernstein wrote the definitive book on risk, titled ***Against the Gods: The Remarkable Story of Risk.*** The book is a bit academic for most, but important nonetheless. In it, Bernstein says of risk, *"The word 'risk' derives from the early Italian risicare, which means 'to dare'. In this sense, risk is a choice rather than a fate. The actions we dare to take, which depend on how free we are to make choices, are what the story of risk is all about."*

Most of us probably think about risk like we think of a traffic signal. Risk increases from none to some to a lot as we move up the light sequence from green to yellow to red. We make decisions nearly every day like this. Not that we all picture a traffic light when we are weighing risk vs. reward, but we are attempting to measure likely outcomes from our decisions. This is part of what makes us human. And by and large, we are pretty good at it.

Unless we are talking about investing. Then it seems as often as not that individualistic determinations of risk vs. reward give way to group think and trend following. It is reminiscent of the child's defensive plea – everyone else did it! And to an extent, this lack of risk awareness for investors is understandable. Information is often incomplete or even conflicting.

Yet whether we perceive it or not, investment risk in some measure is always present. And even when we do perceive risk's presence, we are not all-together clear about how our behavior should be tempered for the risk we perceive.

From our perspective, risk provides opportunity, but not in the manner most might think. High and rising prices are good for those that already hold stocks, but less good for those wanting to buy them. Yet data suggests that more money flows into the market when prices are high than when prices are lower. How can this be if the aim is to buy low?

The answer is simply that when we are uncertain, we take comfort in numbers. If everyone is doing it, why shouldn't we? High prices often beget higher prices, so why not get on board? We perceive there to be less risk when others behave as we do. Higher prices equal less risk because everything is working.

Similarly, when prices are falling we get nervous. We see prices going down and others selling, so we sell too. After all, with prices falling, risk is rising, isn't it?

Not really. It certainly may feel that way emotionally, but in point of fact, risk and price generally move together. As prices rise, so too does risk. And as prices fall, risk declines.

Think about the traffic light again. Green means go. The coast is clear and you may proceed. But it doesn't mean you should abandon all caution. There may be something entering the intersection that doesn't belong there, so move forward but pay attention.

Yellow is a warning that means pay attention and reduce your speed. Circumstances could be changing. In other words, risk's presence is becoming a little more obvious. Don't stop, don't undo anything, but be prepared. Have a plan while you continue to proceed.

Red is where the traffic signal analogy becomes less perfect. On the roadway, failure to stop for a red light could result in an expensive ticket, or worse. In the investing world, the red light should not be taken as a hard stop. Do not sell everything and go hide. The world will most likely not end this time. And if it did, well, we would have bigger problems.

To us, red means risks have elevated as prices have risen, and there is opportunity in this elevated risk. Again, if the objective is to buy low and sell high, and if we bought when the light was green and yellow, red allows us to take advantage and sell high. This reduces our risk by reducing our exposure to those things that have become overvalued. Overvalued securities are typically the ones most susceptible to price declines. Reducing our exposure to them reduces the impact of a down market.

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It isn't holding cash that reduces risk. It is reducing risky assets in our portfolio that reduces risk. And so the red light, like the green, is an opportunity not to be feared. Buy low, and sell high, and have the discipline and patience in between to wait.

The discipline to wait is important, because price matters. Investing just to be invested isn't a strategy. It is a hope. Investing when the price is right is a strategy. It is not about timing the market. It is about appropriately recognizing the presence and amount of risk, and then acting accordingly. We must weigh risk vs. reward.

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Price matters, and history makes this abundantly clear. The stock market was at or near a bottom in 1987, 2002 and 2009. The return for the S&P was far better than average from these lows than from the highs that preceded them. Intellectually this makes perfect sense. Unfortunately, most investors perceived the risk to be too great at those deeply discounted valuations because the market had fallen by 25%, 50% and 50% preceding each bottom. Yet hindsight indicates those times were less risky than when the market was higher. Risk creates opportunity. Be aware of it and take advantage.

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