

Dear Partners,

Risk is a favourite topic of mine. Assessing and managing risk, I believe, is the most important element of investing. It's also the most complicated aspect, and arguably, the most misunderstood. I'd like to explore a few reasons for why I think this is the case.

### **IBV's View on Risk**

Risk is complicated, nuanced, and subjective - and by no means standardized. This is because each investment situation is unique. To assess and manage risk, a high degree of judgement must be applied. Applying this judgement is as much Art as it is Science. No one can precisely quantify risk, though I'm sure many will tell you they can. Risk can't be precisely quantified because its very nature represents the unknown. However, much can be done to avoid risky investment situations. What's required, I've learned, is considerable patience, steadiness, and application of common sense. Before continuing though, we must ask ourselves, how do we define risk?

Webster's dictionary defines risk as:

*"The possibility that something bad or unpleasant (such as a loss) will happen."*

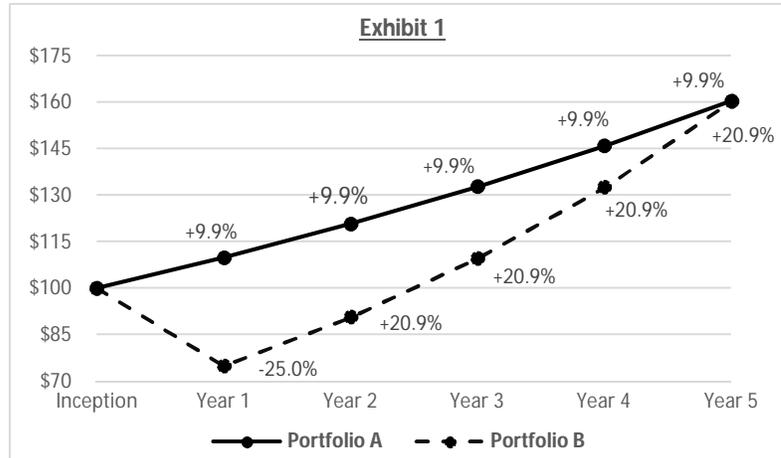
IBV defines risk as:

*"The probability of a permanent loss of capital."*

How we define risk is critical because it dictates what steps should be taken to avoid it. Let's parse our definition of risk by starting with what we consider to be "permanent". To determine what's permanent vs. what's temporary, I focus on the fundamentals of a company (and industry they're part of), and whether they're changing for better or worse. Only potential adjustments in value associated with these fundamental changes are worth reflecting on. In the event that a security we own experiences a negative change to its underlying fundamentals - something that will reduce its future cash flow and intrinsic value - we consider any resulting decline in market value below the security's downward revised intrinsic value as a "permanent loss of capital". I place very little importance on the short-term movements of security valuations. I don't think the underlying value of a company regularly changes by hundreds of millions or even billions of dollars. How can it? Most businesses, on a fundamental level, don't change very quickly. As a result, much of what we see day-to-day in the markets rarely impacts our investment process. For anyone who has privately owned a business, this approach will make intuitive sense.

Moving on, our definition of "probability" is important for various reasons. For one, it's much easier to accumulate attractive long-term returns by earning reasonable returns and avoiding losses altogether, than it is to sustain losses and attempt to earn outsized returns to offset them. Here's a simple example to illustrate why I think this way: Imagine two portfolios running in parallel for five years. Portfolio A achieves a 9.9% gain, which is the S&P 500's 50-year annual average

(including dividends), in each of the five years. Portfolio B, however, sustains a 25.0% loss in year one. For portfolio B to catch up to portfolio A by the end of the fifth year, portfolio B must achieve a 20.9% return in each of the four remaining years. This 20.9% return represents an 11.0% outperformance of the 50-year S&P 500 average for four straight years (Exhibit 1). This is no easy task, and precisely why we focus our investments on securities when the “probability” of a permanent loss is extremely low.



How we aim to reduce the probability of a permanent loss in capital is twofold. For one, we endeavor to buy securities at very attractive prices on an absolute basis - not on a relative basis. This is a nuance we speak quite often about and will discuss further in future writings. The other aspect is to focus on companies in industries whose fundamentals experience relatively small incremental changes, if any at all, over time. When thinking of a company that experiences slow-moving disruptive forces, one might consider a railroad. Railroads have been a viable, efficient, and often profitable method of transporting North American goods and people since the early 1800s. On the other hand, companies in industries experiencing highly disruptive forces might include cell phone manufacturers. Many companies in this industry simply did not exist a decade or two ago; additionally, all of them have fickle customers who regularly upgrade to the latest models with the most cutting edge technologies. What compounds the voracious speed of disruption is the rapidly evolving technology most new models build their platforms on. By buying securities at attractive absolute prices in slow-moving industries, the “probability” of dramatic changes permanently impairing its economic prospects and value below our purchase price, is greatly reduced.

### The Market’s View of Risk

In pursuit of the magic investment formula, unfortunately (but not surprisingly), the investment community has produced a standardized formula to precisely quantify risk. I say unfortunate because this formula for risk has led many astray and has resulted in countless poor investment decisions. Volatility, or the degree of change in the value of a security (we’ll use ‘company’ interchangeably) over time, is thought to be the perfect vehicle to measure risk. It does help quantify, compare, model, and explain risk; however, what volatility does not do, is function as a good proxy for risk.

The critical flaw with volatility is that it doesn’t consider what a security is worth, relative to what it’s currently trading for when it quantifies risk. Let me illustrate: You’re opening an ice cream shop and need an ice cream maker. Not just any ice cream maker, but the ICM 1000. You know the machine is worth around \$100 (its intrinsic value), which is what you’re willing to pay for it. But, being the money-conscious individual you are, you find two vendors online selling the exact same ICM 1000. More research uncovers that the price changes daily and for no apparent reason (much like the stock market). You watch both vendors online for a while and soon find that Vendor A sells

the ICM 1000 for between \$95 and \$105, and Vendor B sells it for between \$70 and \$130. One day, Vendor B posts an ICM 1000 clearance sale and you buy the machine for \$70. Good job. Your patience, research and discipline has paid off. Interestingly though, if volatility was a proxy for risk, your purchase would be deemed a riskier purchase than if you had bought the machine from Vendor A for a higher price. This flawed determination is simply due to Vendor B's selling price being more volatile than Vendor A's selling price over the same timeframe. What the volatility calculation clearly doesn't consider is that you have just purchased a \$100 machine for \$70. We think you've made a sound purchase. For this reason, we don't pay much mind to volatility and its superficial assessment of risk.

I think it'd be beneficial to expand on this practical example by including a technical argument. For volatility to be an effective proxy for risk, one must rely on the efficient market hypothesis. For reasons that will soon become obvious, we don't subscribe to the efficient market hypothesis. Let me connect the dots. If volatility accurately measures risk, then the changing price of a company must accurately reflect the changing risks, or re-valuation of the same risk exposures faced by that company. This is precisely what the efficient market hypothesis suggests happens naturally in markets. To paraphrase, the efficient market hypothesis states that actual prices of individual securities already reflect the effects of information based both on events that have already occurred, and on events which, as of now, the market expects to take place in the future.

From a practical standpoint, a security's price cannot reflect all possible future events and the magnitude of their effects accurately. The sheer number of possible outcomes is infinite. In reality, prices only reflect what market participants believe are possible outcomes of the future. Unfortunately, market participants have historically under-appreciated the wide range of possible outcomes that can occur. To compound this shortcoming, they also miscalculate the actual financial consequences of an event when it does occur. For anyone who has experienced the Savings and Loans Crises, Tech Boom & Bust, Great Recession, European Crises, or a sudden increase or drop in the price of any commodity (including the 1630's Tulip bubble<sup>1</sup> – for our historian aficionados), an argument that the efficient market hypothesis is critically flawed, can be made.

Instead of reconsidering the consequences of this flawed definition of risk, the financial sector has pushed forward with it. They've even gone so far as to create a security out of it. What the VIX<sup>2</sup> (the security that represents risk) tells me is that the financial community misunderstands the origins of risk and doesn't appreciate that you can't financially engineer risk out of an investment. Most business owners would jump at the first opportunity to keep their business, but sell all the risk associated with it. Sorry to be the bearer of bad news, but the reality is, this is not possible.

When I ask a business owner about the risks their company faces, they typically respond with a variety of potential operational, financial, governmental, and/or economic concerns. What I have yet to hear a business owner reference, is the fact that their company's value will change drastically in the coming days, months or years. In other words, business owners don't actually think of company valuation volatility as a true indicator of risk. I agree with them.

---

<sup>1</sup> [http://www.businessweek.com/2000/00\\_17/b3678084.htm](http://www.businessweek.com/2000/00_17/b3678084.htm)

<sup>2</sup> <http://www.cboe.com/micro/VIX/vixintro.aspx>

## The Consequences of our View

How we define risk has a material impact on how we invest and on the composition of our returns. Why is this so? While many avoid volatile securities, since market participants associate volatility with risk, we do not - not if the securities are attractively priced and exhibit the business characteristics we find so appealing. We also don't see a need to actively manage the level of volatility of our portfolio. To do so would in no way reduce the actual level of risk associated with our investments. Our approach may, during distinct periods of time, result in us owning volatile investments and consequently experiencing volatile portfolio returns. However, in the long run, executing our investment approach mitigates actual risks while producing promising potential returns throughout all market conditions.

Sincerely,



Talbot Babineau, CFA  
President & Chief Investment Officer  
T: 416.603.4282 | [tbabineau@ibvcapital.com](mailto:tbabineau@ibvcapital.com)