

## **Redefining Risk**

In investment academia, risk is typically defined as price volatility, or stated another way, the standard deviation of a stock or a portfolio's value over time. This is probably not a good definition of risk. Risk can have much more to do with the investor than with the investment.

At a recent conference sponsored by our investment society (AIMR), Jason Zweig of Money Magazine presented a few examples of number one ranked mutual funds that reflect this redefinition of risk. One of the funds was the Robertson Stephenson Value + Growth Fund. On December 31, 1996, it was rated the number one mid-cap fund for three year return rankings by Lipper Analytical Services. The fund's superior performance was concentrated toward the latter half of this three year return ranking period. As one might expect, the new contributions poured into the fund during the last year of this high-performance period.

For the five year period May 31, 1992 (inception) until May 31, 1997, the fund returned an excellent 27.7%/year return. This was a traditional time-weighted return. However, the fund declined dramatically in early 1997, at a time when the assets in the fund had peaked. When the fund's return is computed on an asset-weighted basis, it drops from 27.7%/year to 3.6%/year. In other words, an investor did well if he invested his money in the beginning and held it there until the end of the five years. Instead, investors waited to invest, missing the good performance and fully realizing the poor performance. Poor timing with investment vehicles like this is not the exception but rather the general pattern of investor behavior.

Time-weighted rates of return over selected periods are the methodology required by our profession, and it is the appropriate return to use when evaluating a fund or an advisor. However, time-weighted returns are not fully understood or appreciated by clients who are not in the investment business. Many clients simply want to know how much money they gave us and how much they have now. That is the period of time that we have our client's money to invest, so it is the only time for which we should consider ourselves accountable. Or, is it?

### **Buy High and Sell Low??**

By definition, the majority of investors cannot be right in the long run. Witness: the above mutual fund and the technology bubble that peaked early last year. The majority of the dollars will arrive and be in-place at the peaks. Similarly, there will be a severe scarcity of dollars invested at the bottom of the trough. This is why a contrarian investment approach works consistently over time but especially at the points of extreme.

The theory of investing is simple. We win by buying low and selling high. But, as noted above, it is the nature of investors to do the opposite -- buy high and sell low. As professional investment advisors, we deal with this by having a contrarian investment philosophy and a buy/sell discipline that is based on fundamentals rather than feelings. This is what we must do every day to try and get the best return possible during the time that our clients' assets are our responsibility.

We believe that our responsibility to our clients extends beyond the things we do to manage their investments. We must work as effectively with the clients as with the investments. This requires that we be good, credible communicators.

You will recall that we have redefined risk (and return) so that it has more to do with the investor than with the investment. Our goal is to maximize our clients' wealth at the appropriate level of risk. When our investments go through a difficult period, it is important that we convince our clients that the fundamentals of our firm and our investment process are sound. This is an on-going educational, selling and confidence-building process. We

must be effective so our clients will not end up selling one advisor low (i.e. us) and buying another advisor high. We must help control both the investor risk and the investment risk.

## **Hard Sales Job**

It is not easy to sell a contrarian investment approach. With investments, being with the crowd is comforting. Going against the crowd is frightening. However, the risks are greater being in the crowd than they are going against the crowd. Like good physical health, good investment health requires an inverted logic. If it feels good (couch potato; stuffed potato), it's bad for you; if it feels bad (exercise; broccoli), it's good for you. It's a difficult sell.

The media exacerbate the problem. It's amusing (vs. informative) to watch the talking heads on CNBC and other media. The faces are the same, but the words are new. A year ago they were justifying technology stock valuations and projecting rapid revenue and earnings growth. Today, in hindsight, these same people state that what happened to the technology stocks was obvious, and only a fool would not have seen it coming. You can question their conviction but not their enthusiasm.

The people in the media are simply doing a naïve extrapolation of what has recently happened in the market. This is not just an affliction of the media, but also of the masses. This extrapolation of the recent past is also what the public does, believes, and wants to hear. The media are selling to the public, so this is what they are going to say. Say something different, and you're off the air.

History has also shown that most people in our profession suffer from this problem. Like the media, mutual funds and investment companies are selling their services to the public. You do not sell effectively by telling investors what they do not want to hear. Because the future is so uncertain, it is easy with investments to justify the current popular position, such as eToys having a great future, Cisco being undervalued, old economy stocks being permanently dead money... When an investment professional, or any honorable person, makes these statements often enough, he begins to believe them, passionately, even when it began as somewhat of a rationalization.

Rationalization is rampant amongst investment professionals. Most firms are able to clearly articulate their investment philosophy and their firm's investing disciplines. However, in 1995 the lion's share of investment firms were labeled as "value" investors. Five years later (2000), the distribution had shifted and value-firms were a rarity. And even with those few firms that state a value-oriented philosophy, we will never forget the numerous articles that were written in the late 1990's about some of these investors' categorizations of Amazon, Cisco and others as cheap or reasonably valued stocks.

While CornerCap's equity investments are up significantly over the last year, almost all of the stock indices were in bear market territory (i.e. down more than 20%) as of quarter end. Many investors are experiencing severe pain and are becoming disillusioned. Most of the pain of this down market should have already occurred, but given the lingering belief that "it will come back," the pain is probably not over yet. Before the market actually does come back, there needs to be fewer believers. Also, when it comes back, the "it" will look much different.

## **The Opportunity**

While we criticize the media and many of the professionals in our industry, we also thank them for giving us the opportunity to more easily identify and reside in the minority – where returns are higher and risks are lower. We have been fortunate in convincing many of our clients of the benefits of joining us on the road less traveled. We know where the road is leading us, but we do not know the length of the trip or the difficulty of the terrain. When the trip is particularly long and difficult, it is our challenge to keep the objectives in clear focus and to filter out the noise from the crowds along the way.