

**In The Wake of Katrina  
Difficult Lessons in Risk Management**

We have all seen the news photographs of how Hurricane Katrina devastated the Mississippi coast and New Orleans. We can hardly comprehend the destructive power of this storm. It tossed interstate bridges around like a deck of cards, tore oil rigs from their moorings, and wiped several of the Louisiana barrier islands off the map. Although the devastated areas will be rebuilt, they will likely never be the same.

Sadly, this tragedy was predicted years in advance. Study after study, warning after warning, all predicted massive flooding of New Orleans. It is eerie to read the early predictions. They foretold exactly what has happened in New Orleans. Parts of the city flooded with up to 18 feet of water that chemicals polluted to form a toxic soup. Even the isolation that resulted from the failure of the communications and transportation infrastructure was predicted. The risk to New Orleans and the region was great. City, state, and federal officials knew fully the risks and the potential destruction that a strong hurricane would bring. Apparently, the

government officials either chose to accept much of the risk or defaulted with their inaction.

**Risky Business**

We all make risk management decisions in our lives every day. No matter what scale of risk we are dealing with, there is a cost to hedge or reduce it, and there is a cost related to accepting the risk and the potential loss. In the world of investment management, and particularly at CornerCap, risk assessment is a critical step in the decision process. In the financial markets, risk and return are directly related; as risk increases, so too do the expected return and potential for loss. But, we have some control on the risk side of the equation. We can decide how much risk we want to accept, given the potential return of the investment. We have less control, however, on the return side of the equation. We know from history that stocks with low valuation multiples for their underlying stream of earnings and cash flows will outperform the market in the long run. That is why our research process focuses on finding high quality companies that trade at attractive valuations. So, our philosophy is to control risk where we can and put the

probabilities for long-term success in our favor.

Unfortunately for New Orleans, the long-term probabilities were not in its favor. According to the National Hurricane Center, during the average century, New Orleans can expect 13 hurricanes, including three to four major hurricanes, to pass within 75 miles of the city. So, it was more a question of when a major hurricane would hit the city rather than whether it would hit. Aggravating the situation was New Orleans' antiquated system of pumps and levees, which increased the risk of flooding from a major storm. Experts predicted that the city could only sustain a category 3 hurricane. The mandatory evacuation order was sounded when Katrina was a monstrous category 5 storm. Given the probabilities for a major hurricane and the subsequent destruction, why was not a plan implemented to remove the city's poor and elderly residents who wished to leave?

**Concentration Risk**

The hurricane risk to the inhabitants of New Orleans is obvious. Not as obvious is the economic risk that the country is taking by concentrating such a high

## Commentary September 30, 2005

percentage of its domestic oil production and refining capacity in the northern Gulf of Mexico. Oil production in the region is nearly 30% of the U.S. total. In addition, the Gulf region serves as the point of entry for 60% of the nation's imported oil. It is home to approximately 47% of the country's refining capacity. In fact, the Gulf coast has more than twice the crude oil distillation capacity of any other region in the United States. Since no new refineries in the U.S. have been built since 1976, many existing refineries are operating close to maximum capacity. Reasons for the lack of new refineries include stringent federal environmental rules, communities' unwillingness to host the sprawling refinery complexes, and the rising cost of operating a refinery, which has historically been a low margin business. So, rather than build new facilities, refiners have added to existing locations, further concentrating the capacity.

Concentration risks are among the easiest risks to reduce and eliminate. Everyone is familiar with the "Don't put all of your eggs in one basket" analogy. In our portfolios, we hold around 40 to 50 different stocks, significantly reducing the

impact of any one stock. In fact, you can eliminate 95% of the stock specific risk by holding a portfolio of at least 30 names. We also look to diversify across various industries and economic sectors. This further reduces the potential volatility of the portfolio. In the end, we want a well-diversified portfolio of high quality companies that trade at attractive market valuations.

Diversifying the country's energy resources across a variety of geographic regions would seem like the common-sense way to reduce the country's concentration risk. However, as with protecting New Orleans from flooding, politics tends to get in the way. Assuming we continue to rely on fossil fuels, it is critical that we get beyond the "not in my backyard" mentality and find a way to disperse our energy assets. After all, Hurricane Katrina only grazed the energy industry in Louisiana. A major storm path's tracking along the Louisiana and Texas coastline would have caused even more damage and disruption to the nation's supply of oil and gasoline. Hurricane Rita was headed directly for this area of the Gulf of Mexico before it weakened and veered slightly east. This

strike to the energy assets in Texas added to the damage in Louisiana resulting in a painful one-two punch.

### Back to Basics

Like 9/11, Hurricane Katrina prompted the nation to assess its ability to deal with disaster from risk recognition to clean up. With Hurricane Katrina, the risk management decisions were clearly misguided. Risk has two components: (1) the probability that an unfavorable event will occur and (2) the impact of that event if it does occur. The risk assessment process begins by evaluating both components. You will likely choose to avoid risks that have either a high probability of occurrence or a high loss potential. Obviously, you will absolutely avoid risks that have both a high probability and a high loss potential. Risk that falls between high probability and high loss potential can be managed.

Fortunately, many investment risks can be successfully managed with a few basic techniques. Investors face two primary types of risks, systematic and unsystematic. All investors face systematic risks, which would include market risk, interest-rate risk, and inflation

risk, among others. In most cases, systematic risks cannot be eliminated but they can be managed through asset class diversification. The systematic risk for New Orleans and that entire region was one of geography. New Orleans is where it is, and this systematic risk cannot be diversified away.

However, in the investment world, geography is not a systematic risk that we must assume for our clients. Similar to factors such as a company's business operations, financial strength, and market valuation, geography is an unsystematic risk that can be essentially eliminated through diversification. New high-net-worth clients frequently come to us holding a portfolio concentrated in local companies. People are more familiar with these local businesses; they want to be supportive of their community; and, anyway, "What could happen?" We do not share their altruism. Witness, New Orleans. Our focus must always be to obtain the highest return for the least amount of risk to our clients.

### **Let The Good Times Roll**

With their French heritage, the people of New Orleans have a saying, "*Laissez les*

*bons temps rouler*"—"Let the good times roll." People frequently get lulled into overlooking the risks they face when times are good. It happened in New Orleans, and it happened to investors during the technology bubble. The valuation risk in the stock market was at record levels at the height of the bubble in March 2000. The price/earnings ratio for the S&P 500 had soared to nearly 37, more than twice its historical level of around 15. As a market-cap weighted index, the S&P 500's allocation to technology stocks swelled to over 35%. Investors responded by believing that, in the new tech economy, things had changed and that the investing environment was somehow different. As you know, the tech stocks and the S&P 500 fell sharply, and the S&P 500 is still more than 10% below the highs it reached in early 2000.

At CornerCap, our investment philosophy and process keep us focused on fundamentals whether times are good or bad. We have a disciplined, unemotional approach that is focused on valuations. We do not attempt to time the market. While some market timers have enjoyed short-term success, no market timing strategy has worked in the long run. Our

approach keeps us fully invested in an asset allocation that is determined by each client's individual needs and not by an asset timing strategy. We also rebalance the portfolios across asset classes and among the individual securities. Rebalancing reduces the portfolio volatility and keeps us buying securities that are relatively underpriced and selling securities that are relatively overpriced.

### **Critical Lessons**

We can learn many lessons from Hurricane Katrina, including basic lessons in risk management. Ultimately, the risk was great that a powerful hurricane like Katrina would inevitably hit near New Orleans and with a devastating impact. Unfortunately, elected governmental officials at all levels chose to assume substantial risks that were known well in advance, and they were not prepared to handle the consequences of their decisions. Investors are wise to heed these lessons. It is critical to understand fully the risks you face and not become complacent when things are going well. The market has a history of humbling even the most brilliant investors.