LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

> "*Also I should like to know about risks . . . time required and remuneration, and so forth"—by which he meant: "What am I going to get out of it? and am I going to come back alive?"*
>
> — Bilbo Baggins in J.R.R. Tolkien's The Hobbit

Risk exists in all aspects of life, including the investment arena. One of the cornerstones of modern portfolio theory is that risk is defined as volatility, and that the primary of objective of portfolio management is to minimize that volatility for a certain level of desired return. A variety of wonderfully sophisticated approaches to the measurement of price volatility have been developed, but the measurement of volatility does not improve your understanding of risk, since the essence of risk is not volatility, but uncertainty.

People worry about risk in non-investment situations where volatility wouldn't even be considered. Worries such as what college to attend, what job to accept, or whom to marry do not boil down to some mathematical equation. A key element in risk analysis—both in the financial arena and others—is scenario analysis where the risk-related questions filter down to these: What are the possible bad outcomes? How likely are they? How bad are they? A simple definition of risk might be something more along the line of *expected pain*.

Volatility may or may not be desirable, but real investment risk is the possibility of permanent loss of capital—losing money and not getting it back. Volatility can actually be used to reduce uncertainty and reduce your investment risk by providing the patient investor with the opportunity to acquire a security at such a low price that investment risk is reduced. When volatility drives a security's price to a large enough discount to your estimate of its true worth, the chance of permanent loss of capital is greatly reduced. Conversely, significant upside volatility requires the disciplined investor to sell securities—even ones with good fundamentals—if a rally pushes prices beyond the value of the investment.

Balancing the risk of permanent loss of capital against the value of an investment, the investor must first understand the fundamentals of that investment. This requires research into the security, its industry, and other considerations for a direct investment. Without knowing what you own, it is impossible to handle the information overload—to distinguish between developments that meaningfully affect value and those that merely move price. Knowledge of the underlying fundamentals of an investment help reduce the uncertainty when the emotion of the market drives price volatility. The market is often described in the short-term as a voting machine driven by the current emotions of investors. At Lawson Kroeker we believe hope and fear make poor investment strategies and prefer to rely on analysis and conviction to reduce risk.

Finally, the distinction between volatility and uncertainty is central to the idea that long-term investors have a competitive advantage over short-term investors. Most investors have greater confidence in their long-term predictions than their short-term estimates. For example, we remain confident that U.S. stocks will outperform U.S. bonds over the next ten years, but have little confidence in predicting whether stocks will beat bonds over the next three months. Adopting a long-term investment horizon does not reduce volatility, but it does increase confidence in expectations. This reduces the level of uncertainty and makes volatility somewhat more bearable.

In this quickly changing world, the only strategy that is almost guaranteed to fail is not taking risk. An assessment of probable outcomes, a long-term view, and an understanding of what you are doing are all essential to *coming back alive*.

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