

The Most Misunderstood Principle in Investing

A quick quiz:

1. To increase returns, you must take higher risks: True/ False
2. Banks are a safe place to put your money for the long-term: True/ False
3. Treasury bonds are risk-free securities: True/ False

The correct answers are given at the end of this column.

Most investors believe that risk and return go hand in hand, i.e., the more risk you are willing to take, the more returns you are likely to earn, and conversely, the less risk you are willing to take, the less returns you are likely to earn. Most investment professionals also agree with this statement. The same opinion is held by most academicians. Indeed, modern finance theory is based on the premise that risk and return are positively correlated.

Many years ago, like almost everybody else, I too, used to think that the only way to increase returns was by taking higher risks. Of course, at that time, I had no answers to questions like "If risk and return are supposed to go hand in hand, then why is it that gamblers in a casino, who seek risk as well as the so-called commensurate rewards that go with it, often lose?" Or, "why is it, that prudent investors, who shun risk, always win?"

Then, one day, I came across the transcript of a talk given at Columbia University in 1984 by the legendary investor Warren Buffett. The talk was titled, "*The Superinvestors of Graham-and-Doddsville*" and two paragraphs in it turned my investment world upside down. Those two paragraphs are reproduced below:

"I would like to say one important thing about risk and reward. Sometimes risk and reward are correlated in a positive fashion. If someone were to say to me, "I have here a six-shooter and I have slipped one cartridge into it. Why don't you just spin it and pull it once? If you survive, I will give you \$1 million." I would decline - perhaps stating that \$1 million is not enough. Then he might offer me \$5 million to pull the trigger twice - now that would be a positive correlation between risk and reward!

The exact opposite is true with value investing. If you buy a dollar bill for 60 cents, it's riskier than when you buy a dollar bill for 40 cents, but the expectation of reward is greater in the latter case. The greater the potential for reward in the value portfolio, the less risk there is."

A few months later, I came across an article written by the partners of an outstanding mutual fund management firm - Tweedy Browne Company LP. In that article, the partners of this firm wrote:

"One of the many unique and advantageous aspects of value investing is that the larger the discount from intrinsic value, the greater the margin of safety and the greater potential return when the stock price moves back to intrinsic value. Contrary to the view of modern portfolio theorists that increased returns can only be achieved by taking greater levels of risk, value investing is predicated on the notion that increased returns are associated with a greater margin of safety, i.e., lower risk."

Several years have passed since I read those passages, and I have found that Warren Buffett and the partners of Tweedy Browne got it right and the academics and most investors got it completely wrong! In order to compound your capital at a satisfactory rate, you don't have to seek risk. Rather you have to run away from risk!

In order to apply this principle correctly, however, you have to understand the true meaning of risk. It is here that the academics have got it completely wrong. They believe in the Modern Portfolio Theory (MPT) which identifies risk with "beta", the past relative volatility of a stock as compared to that of a large universe of stocks. Beta can be calculated precisely, but to identify it with investment "risk" is precisely wrong. Beta measures volatility and

volatility is not the same as risk. According to MPT, if a stock drops sharply as compared to the overall market, it becomes "riskier" at the lower price than it was at the higher price!

The term "risk" to a sound investor means the same thing that the term means to a sound businessman - the possibility of loss. A sound businessman tries not to overpay for the merchandise he deals in. He knows that if he buys something that is worth only Rs. 100 for Rs 150, then he is taking a high risk of losing money. On the other hand, he knows that if he can pay only Rs 50 for merchandise that is truly worth Rs 100, then the possibility of loss is remote but the expectation of a reward is higher. In other words, high risk translate into low returns and low risks translate into higher returns, and that was the correct answer to question # 1 in the quiz at the beginning of this column.

Now let us apply this principle to the other two questions in the quiz. Are banks a safe place for long-term funds? One thing is very clear. If you put your money in a savings bank account held with a public sector bank, then you can be more or less certain that your money, in *nominal* terms, is safe. But, another fact is also certain: your money, left in that bank account, in *real* terms (after adjusting for inflation), is certain to diminish over the years. Therefore, if you consider the factor of inflation, then the logical conclusion must be that savings bank accounts as long-term investments, are highly risky, and as per the principle stated above, likely to produce very poor long-term returns.

The same logic applies to question # 3 in the quiz. Treasury bonds are free of only one kind of risk: credit risk. They are highly risky long-term investments, if you consider the factor of inflation.

Here, then, are the correct answers to the quiz at the beginning of this column:

1. To increase returns, you must take higher risks: False
2. Banks are a safe place to put your money for the long-term: False
3. Treasury bonds are risk-free securities: False

Note

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