CENTERPOINT STRATEGIES

Risk vs. Volatility

Q2 2024 Client Letter

One of the most misunderstood concepts in investing is the difference between market volatility and market risk. Many investors treat these two concepts synonymously, which is a huge mistake and can be detrimental to long term success in the market. Academia equates risk with volatility through various models such as the Capital Asset Pricing Model (CAPM), which uses volatility (standard deviation of returns) as a proxy for risk to determine expected returns. One way to understand it is as follows: Risk is the likelihood that an investment will suffer a permanent loss of value. Volatility, on the other hand, refers to the extent and speed of price fluctuations in an investment over time. Therefore, managing risk is extremely important to any investment portfolio, while volatility is something that should be managed if one needs to withdraw a portion of their money in the near future. The smartest and highest performing investors in the world, throughout the highs and lows, understand this distinct difference very well. They position themselves to take advantage during times of stress when asset prices overshoot to the downside, reflecting the collective belief investors have that the worst is yet to come. The best performing stocks of all time have frequently been in 70-90% drawdowns along the way, especially early on when they were viewed as “risky”. Investors who recognized these rough patches as simply “volatility” and not some sort of dire risk to the future of the business have been handsomely rewarded by holding them throughout the decades, even if earnings have at times disappointed due to cyclicality.

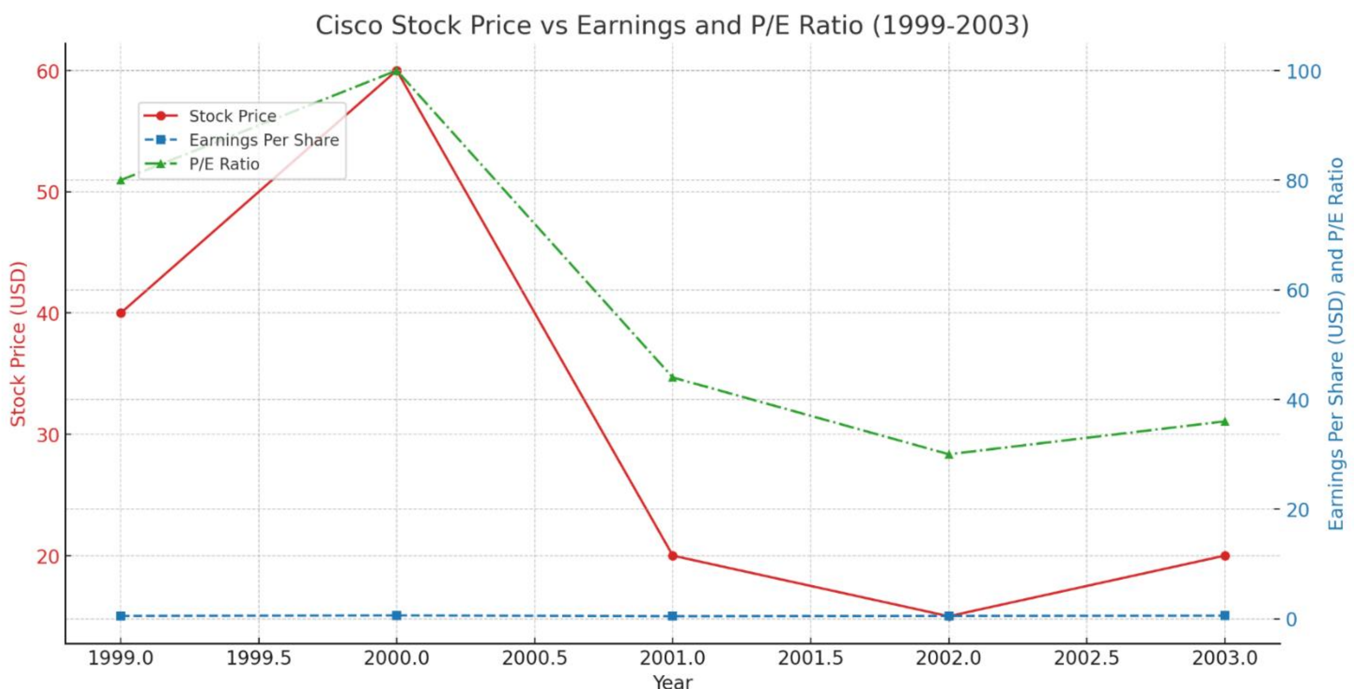
It is notable, however, that risk and volatility do become more correlated as time horizons become compressed due to the impact of sequence of return risk. For example, let’s say you have $100 today and need it for a birthday gift for your spouse tomorrow. If you arrive at the store tomorrow with only $99, you can't buy the gift. In this situation, it would be unwise to invest the $100, hoping to increase it to $101 by tomorrow. The potential satisfaction of an extra $1 wouldn't outweigh the disappointment of losing $1 and not being able to buy the gift. You don't have the capacity to absorb this risk. Now let’s say you have $100 today and need it to maintain its purchasing power in 30 years. Historically, simply keeping the $100 without investing it would be very risky over three decades. While the $100 will still be there, inflation will erode its value to only 41% of today's purchasing power (assuming 3% annual inflation). You simply can't afford this risk, although you wouldn’t have seen any volatility along the way.

On a company specific level, price and value are related, but not identical. An investment's price may experience significant short-term fluctuations, even if its long-term value remains relatively stable. In such cases, it is primarily the market's short-term perception of the investment's value that is changing. Take, for instance, Johnson and Johnson during the 2008 crash. JNJ stock price dropped from around $70 in mid-2008 to under $50 by early 2009, a decline of about 30%. Throughout this period, Johnson & Johnson's revenue and earnings remained robust. The company continued to generate steady cash flow and maintain profitability, with only minor fluctuations in its financial performance. If you were to look at the actual earnings of the company during that period, you can’t even tell that there was a recession. There is a very good reason why this company is on its 62nd straight year of increasing its dividend. So then, what are the types of things that pose a risk to this

juggernaut? One notable example is the fact that JNJ must maintain a constant, robust pharmaceutical pipeline to mitigate lawsuits from their older products. This is a very valid risk that needs to be taken into consideration, and it cannot be explained by some formulaic model that solely incorporates the stock's volatility over a time frame in comparison to the overall market's volatility.

How can one analyze and try to reduce some of the true investment risks that are out there? Well, one way this can be accomplished is by buying companies with wide economic moats. This idea originally was coined by Warren Buffett, when describing the competitive advantages some firms have that keep them insulated from competition – like a moat that protects the castle. His purchase of Apple in 2016 demonstrates confidence in the entrenched position Apple has in the lives of consumers. Even though consumer preferences change all the time, Apple has been able to develop and grow an ecosystem within the company that has been nearly impossible to disrupt. That economic moat has flowed down in the form of massive share price gains and dividends to Warren's now $135 billion position, or about 40% of the value of Berkshire Hathaway's stock portfolio!

Another way to reduce investment risk is to not grossly overpay for stocks. Occasionally, there are a handful of stocks that are labeled as bullet proof or invincible. Although this may be true with respect to their brand, competitive moat, or value of the franchise among consumers, if you pay too high a price for the company's stock, that may introduce a risk that can be detrimental to your long-term success. Take, for instance, Cisco in 2000, hailed as the "King of the Internet" back then. The revenue of the company was nearly $19 billion USD in fiscal year 2000 and has grown to $57 billion through 2023. Today, it still is the same dominant company in networking and telecommunications. Back in 2000, though, the price investors paid for those forward sales and earnings turned out to be highly unsustainable. In turn, CSCO stock still has not made a new high since the top in 2000, a devastating mistake if you were putting money in the stock 24 years ago at nosebleed valuations.



Lastly, it is essential to not put all your eggs in one basket. This is a relatively well-known concept among people who have capital to deploy or grow over long periods of time. Adopting a robust diversification strategy that considers valuations across different asset classes, as well as your time horizon and liquidity needs, is essential for successful investing. It is also important not to “di-worsify” via spreading capital in too many places, or simply owning too many investments. If you invest in companies with wide economic moats at or below their calculated fair values and diversify appropriately, your risk of permanent capital loss is extremely low. In the context of a properly put together portfolio, it is essential to view volatility as your friend, not your enemy. And, of course, always remember that no one has privileged access to the future. Long-term compounding always comes with inevitable ups and downs. We view the downs as opportunities.

Sincerely,

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