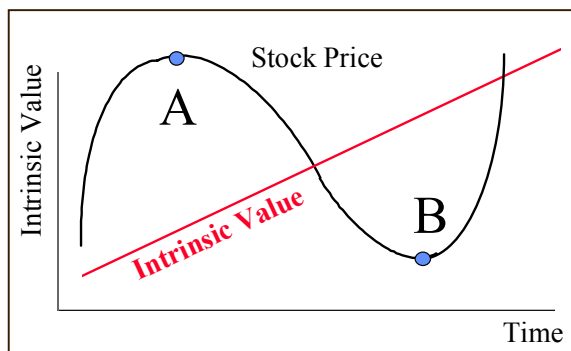


RISK VS. RETURN

Academics have long sought to define, measure, and propose ways to manage risk as a key element in portfolio management theory. Within Modern Portfolio Theory (MPT), the relatively new quantitative construct enabled by the computer age, are three central tenets regarding uncertainty: 1) risk and return are *directly* related, 2) relative price volatility is the best proxy for risk and 3) risk is presumed to be constant irrespective of price.

The Efficient Market Theory (EMT), a critical assumption upon which MPT is built, contends that the market price that clears supply and demand at a given moment in time is a full and adequate representation of the underlying value of the business. Hence, any and all price fluctuations are the result of previously unknowable and therefore random events. Assuming this to be true, *price volatility* defaults as the standard proxy for risk. Logic would then suggest that in order to achieve higher returns, one must seek investments where the likelihood of price volatility is more pronounced—investments where uncertainty is more probable. This is the commonly held belief.



The graphic above is Martin Capital Management's hypothetical simulation depicting the juxtaposition of a business' market price and its intrinsic value over time. The message it communicates is in start contrast with MPT. The concept is predicated on the belief that every business (in our universe of investment candidates) has a calculable intrinsic worth, which is not always reflected in its market price. It is a

belief that was central to the teaching of Ben Graham in his 1934 classic *Security Analysis*. (The book has become a collector's item, with some copies selling for over \$1000—until it was reproduced in 1997.) That one difference in philosophy changes everything. Rather than using volatility as a measure of risk and return, we prefer to think that risk and return are a *function* of the relationship between the market price and the intrinsic worth of the business. Of course, one must be able to, with a reasonable margin of error, uncloak intrinsic value (see insert on Equity Selection Discipline). Looking at the graphic to the left, under the assumption that an approximation of intrinsic value is discernible, we hold the view that for this hypothetical example the risk/return profile is radically different at point A than at Point B. A disciplined purchase (always required when prices are going down) at or around point B will expose the investor to less risk of loss *and* should result in an expected return well in excess of the rate at which the business itself is growing. So, the successful management of risk (and the coincidental bonus of increased opportunity) is highly dependent on buying great businesses (e.g. those with relatively predictable and upward sloping intrinsic value lines) at prices at or below the line.

Benjamin Graham distinguishes investment from speculation as follows: "An investment operation is one which, upon thorough analysis promises safety of principle and an adequate return. Operations not meeting these requirements are speculative." In defining risk as the potential for something to go horribly wrong, we feel that every investment should be purchased at a price that provides an acceptable margin of safety. Absent an adequate margin of safety, an investment is easily transformed into a speculation. From our perspective on risk, a compelling margin of safety at purchase affords us two clear-cut advantages: 1) if we should error in the fundamental assessment of the business, the risk of loss when we exit is reduced by virtue of the margin of safety and 2) if our fundamental work

proves to be accurate, the holding period return should exceed the rate of growth of the intrinsic value of the business itself.

