Investing about understanding risks

Money Matters

Mark Williams

Investing is not about avoiding risk. It is about understanding the risks and pricing the risk accordingly, which is why we refer to risk and return. The return must be commensurate with the risk taken. The trick is understanding risk.

If you ask the "talking heads", otherwise known as financial commentators, what are the risks today, they'll all sing from the same hymn sheet in listing the following risks facing investors:

- geopolitical crisis in respect of the Russia-Ukraine threat;
- high inflation and rising interest rates; and
- high prices.

The mistake investors make is defining volatility as risk. If volatility is indeed the definition of risk, then the threatening crisis in eastern Europe is a massive risk for a share market correction; as is inflation and rising interest rates, which is inextricably linked to higher volatility.

The mainstream consensus view of the financial services industry that volatility of return is indeed risk is so entrenched that even Wall Street fails to price risk correctly. Portfolio insurance is priced off volatility.

The higher the volatility the higher the cost of insurance, which seems intuitive, right? No, wrong!

Let's say we do have a war in Europe and share prices collapse sending the VIX (Chicago Board Options Exchange's CBOE Volatility Index) through the roof and the cost of buying insurance with it. Buying expensive insurance after prices have collapsed is akin to closing the barn door after the animals have escaped or taking out insurance after your house has burnt down.

On the flip side the cost of insurance is cheapest when markets are at peak levels and thus facing the biggest risk of falling, which makes absolutely no sense, if you understand that risk is not volatility, but permanent loss of capital.

Permanent loss of capital can only come from high prices. Overpaying for assets will result in a permanent loss of capital and that is the real definition of risk.

Temporary losses caused by panic selling and the resultant volatility is not risk for the long-term investor in the knowledge that prices will always recover given time; with the caveat that you didn't overpay. In fact, volatility creates the opportunity for long-term investors to exploit the irrational price behaviour of speculators by buying assets at a discount.

Ben Graham, the father of value investing and Warren Buffet's mentor famously stated: "Prices are what you pay; value is what you get."

The chart depicts the importance of buying quality businesses at fair prices – not all tech is equal.

While the Nasdaq has come under extreme pressure this year, the real pain has been felt in the non-profitable overpriced tech companies with a permanent loss for investors.
– *www.mwwealth.co.za*