The best way to handle risk is to be a value investor

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By George Athanassakos
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A fundamental tenet of modern portfolio theory is the notion of diversification. Rather than holding one or a few stocks, investors instead should hold a large basket of stocks.

A strategy that attempts to outperform the market based on stock picking - in other words, selecting stocks that seem to be underpriced - will lead to a poorly diversified portfolio and risk for which there will be no reward. According to the theory, diversification helps investors minimize risk and, so doing, avoid losses.

The notion of diversification, however, assumes that risk can be measured. Events over the past two years have cast doubt on how risk should be measured and have forced many believers in modern portfolio theory to reassess their models and risk metrics. They have come to realize that risk depends on too many (known and unknown) variables to be accurately measured.

Surprisingly, this realization is not new. As early as 1930, John Maynard Keynes had indicated that uncertainty and risk could not be quantified and measured. Unfortunately for Mr. Keynes, English clergyman and mathematician Thomas Bayes had a different opinion of risk, that risk could be quantified and measured by a probability distribution, and his views prevailed over those of Mr. Keynes and dominated modern finance theory. It is thus Rev. Bayes whom investors can thank for the importance of diversification in modern portfolio theory.

Adhering to this idea of measurable risk, investors over the years loaded up on risk, believing that risk is eliminated through diversification or diversification's derivatives, such as securitization and structured investment vehicles. The problem is that adherents to this idea of measurable risk did not count on the likelihood that something completely unexpected would occur.

The past few years have shed doubt on the measurability of risk on which most finance models are based. The large number of mathematicians and finance PhDs working on Wall Street and their models were proven wrong because they put too much emphasis on probability distributions and diversification. Moreover, rapid innovation in financial markets made useless many of the tools and statistical models upon which risk managers relied.

For diversification to work, one needs to find securities or assets that have low correlation with each other - correlation that is measured using historical data. And then one needs to expect that future correlations will be the same as they have been historically.

If historical correlations prove to be an inaccurate measure of future relationships, then diversification that is based on this historical relationship will not work. As Mark Twain said, forecasting is difficult, especially when one deals with the future.

Value investors have implicitly aligned themselves with Mr. Keynes. They also understood that risk cannot be measured. That is why they developed the concept of Margin of Safety - not buying a stock unless it falls significantly (about 30 per cent) below its intrinsic value.

While modern portfolio theory regards diversification as a substitute of due diligence, value investors beg to differ. While modern portfolio theory and diversification reject a case-by-case stock analysis, value investors think otherwise.

While modern portfolio theory argues that diversification will save us all, recent events have proven otherwise. Valuing individual securities is not a wasted effort.

Value investors have more concentrated portfolios, not because they reject diversification, but rather because they operate within the boundaries of their competence; they select only securities they understand; they prefer companies with stable cash flows and a history of steady earnings that can be reliably valued.

They buy businesses cheap, based on their assets or future earnings. They never pay for growth - this is an additional way to protect their capital and limit risk. And then they apply a margin of safety, which provides downside protection and which is totally distinct from diversification.

Additionally, to manage risk, value investors try to understand why they are buying and what they buying. They also like to look at investment opportunities intuitively; if something does not make intuitive sense, they are skeptical.

Value investors choose to hold cash when they can't find underpriced stocks. A lack of new opportunities is a sign to value investors that the market as a whole may be overvalued. This is not a market timing call made based on a macroeconomic forecast. It is the result of a bottom-up search for good investments that, at the moment, comes up dry.

George Athanassakos, gathanassakos@ivey.uwo.ca, is a finance professor and holds the Ben Graham Chair in Value Investing at the Richard Ivey School of Business, University of Western Ontario.