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A value investor's take on diversification and risk

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The two key tenets of modern portfolio theory is that investors invest in well-diversified portfolios and that, in this setting, the only risk that matters is beta – a measure of a stock's volatility in relation to the market. Finance courses at universities around the globe and the CFA program are embedded in these two concepts.

Value investors reject both parts of modern portfolio theory.

The notion of diversification

According to theory, in efficient markets, investors will not be rewarded for risk that can be diversified. 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. Diversification helps investors minimize risk and, so doing, avoid losses.

The notion of diversification, however, assumes that all risk can be measured, namely, risk that we know we do not know and risk we do not know we do not know! This realization is not new. As early as 1930, John Maynard Keynes had indicated that some of the risk in the stock market could not be quantified and measured. Unfortunately for Keynes, English clergyman and mathematician Thomas Bayes had a different opinion of risk, that risk could be quantified and measured by a probability distribution (like putting bets on roulette and observing and plotting the outcomes in a bell curve). His views prevailed over those of Keynes and dominated modern finance theory. The notion that risk resembles a game of roulette has permeated modern portfolio theory and risk-management strategies. But the bell curve assumes that we know what we do not know. In roulette, the odds are known and what investors do does not affect the odds. Unfortunately, the stock market is not like roulette, but rather like a poker game in which the odds are affected by what we observe around us.

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 we did not we did not know would occur. In recent years, a large number of mathematicians and finance PhDs working on Wall Street and their models were proven wrong because they put too much emphasis on bell curve probability distributions and diversification.

Value investors have 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. "The right method in investment is to put fairly large sums into enterprises which one thinks one knows something about," Keynes wrote. And Gerald Loeb, co-founder of E. F. Hutton, wrote in his 1935 book on *The Battle for Investments Survival*, "Once you attain competence, diversification is undesirable."

Why beta?

Finance academics define risk as volatility or its derivative, beta. But is beta relevant? Is beta an appropriate measure of risk? TD Waterhouse reports that Intel Corp.'s beta is 0.88, while Sierra Wireless beta is 0.66. Based on beta, Intel is a riskier company than Sierra Wireless. But does anyone believe this? For value investors, volatility is not an appropriate measure of risk. Value investors see risk as the probability that adverse outcomes in the future will permanently impair the business's potential cash flow and investor's capital.

What is material for value investors is whether a company continues to have strong long-term prospects and fundamentals, be well managed and financially sound, as well as "cheap" – that is, its stock price is significantly below the intrinsic value (by a predetermined margin of safety). Value investors want to ascertain that a company has the ability, financial and operational, to withstand adverse states of the world and "sustain pain." In the absence of the above, companies will have high probability of "permanently impairing their business's potential cash flow and investor's capital" during bad economic times. In this sense, value investors have implicitly aligned themselves with Keynes. That is why they developed the concept of margin of safety (MOS) – not buying a stock unless it falls significantly (about 30 per cent) below its intrinsic value. The MOS protects investors from the unknown unknowns.

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