Thornburg Investment Management™

April 2005

Risk: *More than One Definition*

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Most professional investors and advisors regard risk primarily as a statistic: standard deviation of a return series. Standard deviation is attractive to its constituency because it is easy to calculate and provides some information about portfolio returns. It also helps to compare portfolios over a defined time period. Many financial advisors use standard deviation in their screening processes to find new funds, and Morningstar also bases its Star ratings on volatility.

William Poole, President of the Federal Reserve Bank of St. Louis, recently commented:

"To judge risk, we start by computing the standard deviation from a long history of price changes in some particular market. The normal distribution is the baseline case. What we in fact observe are "fat tails," by which we mean that there are many more large price changes – changes out in the tails of the distribution – than expected with a normal distribution of the calculated standard deviation. Failure to take adequate account of fat tails is responsible for many failures of financial firms over the years, such as the 1998 failure of Long Term Capital Management." [1]

We can conclude from his comments that standard deviation, is, in fact, the de facto standard for measuring risk. The fat tail argument also addresses the fallibility of standard deviation: that in extreme scenarios, really bad things can happen because returns are not normally distributed.

Retail investors tend to worry less about volatility, and more about losing money. Because standard deviation is used to measure risk, investors often associate volatility with the risk of losing money, although the two are not necessarily the same thing. A portfolio can be more volatile than its index yet be less risky, in terms of losing money, if the volatility is primarily occurring on the upside and the portfolio is able to provide downside protection. You could reasonably expect a concentrated portfolio to be more likely to exhibit these types of characteristics.

Charlie Munger, Vice Chairman of Berkshire Hathaway, recently had the following to say about concentrated portfolios:

"The basic idea that it was hard to find good stocks and hard to find good investments and that you wanted to be in good investments, and, therefore, you'd just find a few of them that you knew a lot about and concentrate on those seemed to me such an obviously good idea. And indeed, it's proven to be an obviously good idea. Yet 98% of the investing world doesn't follow it." [2]

Charlie Munger's basic view of investing highlights what we believe to be the best form of risk control: knowing what you own. Performing thorough research and understanding the companies in the portfolio is the best way to minimize risk. Unless you have unlimited resources, this means fewer names in the portfolio – it's hard to be intimate with 200 stocks. Fewer stocks means more volatility. Risk is not entirely reflective of reality if you believe the market is not fully efficient.

Most great investors obviously do not believe in the efficiency of markets. Warren Buffett, Chairman of Berkshire Hathaway, explains both the lack of market efficiency in pricing financial assets and the risks in relying on beta, in a now-famous speech called "Superinvestors of Graham and Doddsville":

"One quick example: The Washington Post Company in 1973 was selling for $80 million in the market. At the time, that day, you could have sold the assets to any one of ten buyers for not less than $400 million, probably appreciably more. The company owned the Post, Newsweek, plus several television stations in major markets. Those same properties are worth $2 billion now so the person who would have paid $400 million would not have been crazy.

Now, if the stock had declined even further to a price that made the valuation $40 million instead of $80 million, its beta would have been greater. And to people who think beta measure risk, the cheaper price would have made it look riskier." [3]

Beta shares many of the benefits and pitfalls of standard deviation, and is similarly backward looking. Buffett gave that speech in May of 1984, even before the current obsession with consultants and modern portfolio theory.

In the Thornburg Core Growth Fund, we take the "Munger" route: knowing what we own. We own less than forty stocks, and we know them very well. Given the fundamentally intensive nature of our process, it would be hard to have 200 stocks in our portfolio, and, as the portfolio manager, I couldn't know them all as well as I would like to.

We seek to control risk by consciously diversifying our portfolio by capitalization range, by sector and within sectors, and by basket (Growth Industry Leaders, Consistent Growth Companies, and Emerging Growth Companies). Moreover, since we focus our research efforts on identifying stock-specific risks – knowing the business model, the accounting issues, the competitive, regulatory, and legal risks, and the quality of earnings being generated – we feel we are controlling our risks at the most basic and important level, the individual securities.

[1] "GSE Risks," William Poole, President, Federal Reserve Bank of St. Louis, St. Louis Society of Financial Analysts, St. Louis, Mo. Jan. 13, 2005 (http://www.stlouisfed.org/news/-speeches/2005/1_13_05.html)

[2] Charlie Munger, December 31, 2004 issue of Outstanding Investor Digest.

[3] Warren Buffett, 1984, speech given at Columbia University.