Our Approach to Risk

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Risk and risk management is fundamental to business in general and investing in particular, and with the heightened volatility and uncertain future due to COVID-19, risk management is something many investors are thinking about at the moment. But risk management is not something that an investor can afford to start thinking about when things start to go wrong. Risk management needs to be baked into the investment process from the very beginning, and at Focus Capital Management that is precisely what we do.

Although risk can be dissected and viewed in many different ways, there are essentially two competing worldviews that underpin how to view and assess risk and how to control and manage risk. In this Strategy Paper, I will discuss how we at Focus Capital Management define risk, how we try to minimize risk, and why we approach risk in this way.

Understanding our approach to risk begins with understanding the essence of our investment philosophy. At Focus Capital Management, we are long-term value investors. As *value* investors, we believe that there are companies which are undervalued and companies which are overvalued. The market price at any point in time is not proof as to intrinsic worth; markets are not fully efficient. As *long-term* investors, we understand that it can take time for our assessment of intrinsic worth to be recognized by the market and that in the meantime the stock can remain undervalued or become even more deeply undervalued. This bedrock foundation of long-term value investing informs and guides every step of our investment process – especially our definition of risk and our approach to dealing with it.

What is Risk?

Much of the investment world focuses on the risk of *volatility*, and this is measured in a number of ways – e.g., standard deviation, beta, Sharpe ratio, etc. Volatility is a legitimate risk for *short-term investors*. Short-term investors need to worry that volatility may bring their portfolio to a temporary low precisely when they wish to exit.

At Focus Capital Management, we are long-term investors. As long-term investors, we are not scared by volatility. We are ready and willing to ride out temporary volatility swings for long-term returns. As we often like to say, by being willing to endure some short-term volatility, we thereby enable steady long-term gains.

As long-term value investors, the risk that we focus on is permanent loss of capital, not short-term market swings. The risk that we focus on is that our assessed gap between trading price and intrinsic worth may be mistaken, illusory, or vanishing. The risk that we focus on is the possibility that we fundamentally misvalued the company and bought an overvalued investment instead of an undervalued investment, leading to permanent loss of capital. This is the risk that we focus on and the risk for which we optimize our investment process.

Properly understanding which risks we are dealing with as long-term value investors changes, of course, what methods must be used to deal with and mitigate these risks. The methods used to deal with the risk of permanent loss of capital due to misvaluation are fundamentally different from the methods used to deal with the ephemeral risk of temporary volatility from market swings. Which leads us straight to the next topic, how Focus Capital Management approaches risk mitigation.

Our Approach to Risk

Mitigating Risk

Our approach to mitigating risk splits into two parts, pre-purchase of the investment and post-purchase of the investment. We will start by discussing our pre-purchase risk mitigation.

Pre-purchase Risk Mitigation

There are two approaches to managing risk when constructing a portfolio. One approach is to embrace risk, to seek out situations with high risk and even higher gain. You can think of this as the venture capital model, where you have many failures for one or two massive hits. Naturally, this approach places a high premium on diversification, to spread out the high risk of failure over many investments. The risk of misvaluing a company is dealt with through diversification. This is not our approach at Focus Capital Management.

Our approach to managing risk when constructing our portfolio is to only invest in situations which we assess to be low risk to begin with – investments with limited downside and great upside. As value investors, we search for undervalued companies with a substantial margin of safety between the trading price and intrinsic worth. This margin of safety provides a cushion of protection even if future events do not proceed precisely as anticipated. Indeed, a core feature of value investing is that the very source of superior returns (purchasing companies which are undervalued vis-à-vis their intrinsic worth) is itself the source of lower risk.

Assuring that this all-important margin of safety is real and not mistaken, illusory, or vanishing necessitates both a distinct sort of investment and a distinct sort of investment process. On the investment side, we seek to invest only in companies which are both Predictable and Resilient. Predictable companies are companies in which we can achieve a firm conviction in their future prospects. In general, the more moving parts contributing to the success or failure of a particular business, the more difficult it is to pin down the company's prospects and the greater the range of intrinsic values that a careful analysis will produce. Companies that are too heavily dependent on commodity prices or macroeconomic factors usually have too many uncertain inputs to be able to reach a firm conviction that they are undervalued, and we generally avoid such companies for that reason. Conglomerates with a number of disparate divisions driving results often have the same issue, and once again, we generally avoid conglomerates for that same reason. These are just examples, but the basic point is that to reduce the risk of misvaluing an investment, we insist on only investing in companies in which we judge the company's future prospects to be sufficiently predictable to achieve a firm conviction of the company's true intrinsic worth.

Resilient companies are companies that can survive and recover from an unexpected shock, be it a global macroeconomic slowdown, regional troubles, or an idiosyncratic company-specific issue. Not everything will always go as expected. (If we needed any proof, just witness what a massive unexpected shock COVID-19 has been to the entire global economy!) Even though we as long-term investors are ready to ride out rough patches, this will not help us if the companies we invest in are not themselves equipped to ride out recessions, business cycles, or other issues. Hence the insistence on investing only in Resilient companies. In judging a company's resilience, there are a number of factors to consider. Resilient companies need strong balance sheets, with little or no debt. What debt they have must be spread out over time so as to lower the risk of needing to refinance during a credit freeze. Resilient companies need to have relatively little reliance on a single big customer or supplier, they need to have low risk of highly disruptive regulatory changes, and they need to have a flexible and secure business model. Resilient companies are generally profitable; money-losing businesses are quite often only one misstep from disaster. Resilient companies need to be in control of their future, not at the mercy of circumstance.

On the investment process side, we seek to invest within our Circle of Competence and to base our investment decisions on Deep Research. Investing within our Circle of Competence means exactly what it sounds like, investing only in those companies where we feel that we have sufficient understanding of the industry and the business model to accurately assess the company and its prospects. Some companies have esoteric technology which we do not feel competent to assess. Some companies operate in sectors where we do not feel we really understand what is driving the company's business. We are always eager to expand our circle of competence by learning about more sectors, industries, and geographies, but we want to expand our circle of competence *before* investing in a company that requires it, not during on-the-job training.

Deep Research also speaks for itself and is one of the major drivers behind the success of our ultra-concentrated portfolio, which allows us to spend 1-3 months researching a company before committing to invest. We believe that a high percentage of mistakes made by investors is due to insufficient research. An investor needs to fully and deeply research the company and its industry to achieve a complete and accurate analysis of its future prospects. For a complete explanation of what we mean by Deep Research and why we consider it crucial to investing, we refer you to our Strategy Paper from Q2 2019, aptly named Deep Research.

Post-purchase Risk Mitigation

After investing in a company, risk management is far from over. At Focus Capital Management, we mitigate risk after investing through a three-tier monitoring process – Constant Monitoring, Periodic Reviews, and Annual Reassessments.

Constant Monitoring

With our super-concentrated portfolio, it is relatively easy to keep abreast of the newsflow relevant to our portfolio companies. More importantly, through our extensive research and deep analysis of the companies we invest in, we build a model of what information is truly important and which metrics to watch closely. With our deep research and analysis, we strive to reach a comprehensive understanding of the company and what makes it tick. From the moment we buy, we understand precisely why we bought, what we expect to happen, and what future events will confirm or disprove our investment thesis. This allows us to slot new information into place as it becomes available. If you don't know your destination, it is impossible to tell if you're heading in the right direction. Without the deep research-based understanding, you cannot know whether to drop a struggling company or to remain patient through the downturns. Countless times, we have seen the market overreact to news that was truly unimportant to the company's long-term prospects, or conversely we have seen the market underreact and not appreciate the true import of superficially unimportant news.

Periodic Reviews

In addition to constant monitoring of industry and company developments, we schedule periodic reviews of each company in our portfolio. With most companies, the natural timetable to schedule these reviews is around quarterly earnings releases. The point of periodic reviews is to be able to take a step back and not get lost in the day-to-day minutiae. To take a step back and see the bigger picture of what progress is being made.

Annual Reassessments

In addition to quarterly reviews, we also annually reassess the company from the ground up, with a particular focus on valuation. The idea is to look at the company with fresh eyes and question our basic assumptions. If we were starting from scratch and didn't already own this company, would we now want to buy it? Scheduling set times to review a company's prospects and its valuation is greatly helpful in reducing the seat-of-pants approach that often accompanies investment decisions. Reactions made on a day-to-day basis are often subject to overreacting to day-to-day news and day-to-day moods and is not the best way to rationally approach risk management and the decision of whether to sell, hold, or buy more.

Conclusion

Successful investing absolutely requires a thought-out, intelligent approach to risk and risk management. At Focus Capital Management, we base our approach to risk on the solid bedrock foundation of long-term value investing, which is at the core of everything we do, and we believe this is one of the keys to our success.