

Risk: Control What You Can and Manage What You Can't

In the world of finance, risk is often defined as beta or standard deviation, both of which measure the volatility of the price of a stock. Volatility is a convenient, academic definition of risk because it can be encapsulated into one objective number and it can be both calculated historically and extrapolated into the future. In addition, since volatility implies that investors themselves view risk as fluctuations in the stock price, it typically has a negative connotation. However, we would argue that, in the short term, volatility should be welcomed since it creates opportunities to either buy or sell, by taking advantage of mispriced securities in the stock market.

The real risk that we worry about at Sionna is losing money also known as a permanent impairment of capital. There are many ways to control this risk. In his book, ***The Most Important Thing***, Oaktree Capital Management's CEO Howard Marks argues that investors can make a judgement about the risk of loss based on (a) the stability and dependability of value and (b) the relationship between price and value. What he means is that risk is best controlled by understanding the underlying business and by having a good sense of what the value of the business is relative to the price at which it can be purchased.

At Sionna, we also believe that managing the risk of loss is a fundamental part of the investment process. Risk management starts with understanding the fundamentals of the business we are buying and what obstacles may challenge our thesis. We spend a lot of time analyzing a company's competitive advantages and whether they are sustainable to get a sense of whether the returns the business has historically generated are likely to continue into the future. We interview the management team to understand how they think about the business and whether their interests are aligned with ours as shareholders. We examine the balance sheet to ensure that we are not exposed to outsized financial risk.

Once we assess the fundamental risks in the business, we then determine what margin of safety would be appropriate for us to consider making an investment. We use different methods to value the business (including our Intrinsic Value Model, Enterprise Value to Free Cash Flow and Net Asset Value), focusing on what the company has accomplished in the past and gaining confidence in what the company may earn going forward. When we are comfortable with our estimate of the business's worth, we then look to the relationship between price and intrinsic value. Our aim is to purchase a company when its price is significantly below our estimate of its long-term value.

There are many reasons why a gap may exist between price and value. Understanding the reasons why a stock is unpopular or misunderstood helps us, as value investors, take a contrarian stance. Perhaps the company is undergoing a cyclical downturn, which is reflected in its poor results. Perhaps the stock has a small market capitalization and is under-followed. Perhaps there are high levels of insider ownership, making the stock relatively illiquid. Provided the company meets our qualitative criteria, then short-term mispricing can represent very good opportunities to buy. Equally important, buying something for less than its value minimizes the risk of loss and permanent impairment of capital.

After a period of strong investment returns like that which we have just experienced, it is easy to become complacent about risk, especially since true risk of loss is only apparent after the fact. However, it is precisely in these good times that investors need to be more vigilant and focused on managing the risk in their portfolios to avoid permanent losses should adversity strike. Ensuring that investments are made with a significant margin of safety and understanding what inherent and fundamental flaws may exist in a potential investee company are both critical factors to controlling investment risk and preserving capital in the long term.

These factors remain as important today as they have ever been.



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