Taking Risks with Risk Management: A Tragedy of Errors

Artisan International Explorer Strategy

PORTFOLIO MANAGER
Viewpoints

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The sudden collapse of Silicon Valley Bank (SVB) and other regional banks brought risk management to the forefront of collective consciousness in early 2023.

Maybe because we are based in the San Francisco Bay Area, even some of the casual conversations we overheard at coffee shops seemed to center on risk management post-SVB implosion. Successful risk management requires averting disaster; it is seldom lauded when handled well but is often thrust into the limelight when it fails.

Even before the Wall Street Journal reported SVB lacked a chief risk officer for a long period before disaster struck, a lack of risk oversight at SVB seemed like common knowledge. People have a tendency (termed "recency bias" by behavioral scientists) to overemphasize and overestimate the likelihood of recent occurrences repeating in the future. As a result, it would not be surprising to see it become common practice for a suburban banking customer to demand an organizational risk management chart before opening a bank account.

Duration risk (a culprit in the SVB saga) is just one of the many risks we, as investment managers, think about. Although the dramatic downfall of SVB certainly had significant impacts on investors, being a large US company sheltered it from additional risks which could have further exacerbated the situation. In comparison, investing in the small-cap space outside of the US can feel like walking through a minefield. Much of the analysis on companies like Microsoft or Nike can be done from your bedroom and, more often than not, you can count on the board of directors to be functional and to protect minority shareholders. In many parts of the world, however, you cannot make such assumptions.

> Whether we're comfortable with the people on the other side of the table is almost always the first thing we check—we call it our initial smell test. If they don't pass our smell test, we don't bother with reconciling the numbers, and we certainly don't care how cheap the share price looks. As non-US small cap investors, we face many additional risks which we must try to mitigate in order to successfully maximize long-term returns.

But before we get into the weeds of highlighting the myriad risks we face and our methods of addressing them, let us engage you in a simple exercise.

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A R T I S A N P A R T N E R S

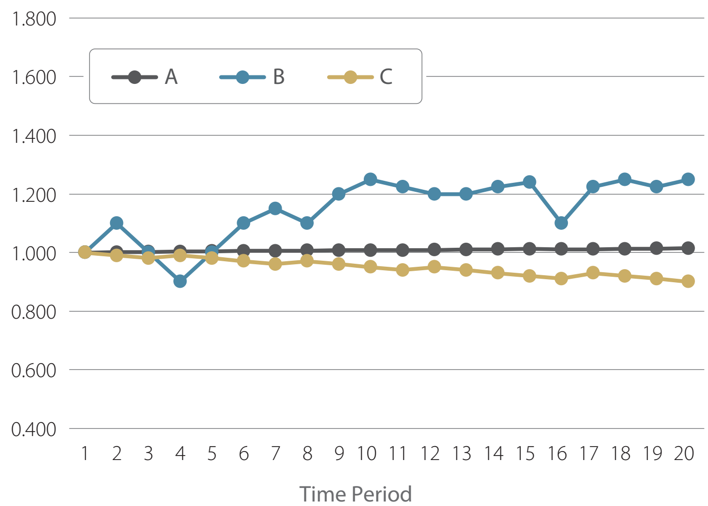
Please see the prices and performance of three fictitious securities (A, B and C) over time (twenty periods) below. Just based on these data points, we ask you to rank them from riskiest to least risky.

Exhibit 1: Illustrative Stock Prices

Time Period	A	B	C
1	1.000	1.000	1.000
2	1.001	1.100	0.990
3	1.002	1.000	0.980
4	1.003	0.900	0.990
5	1.004	1.000	0.980
6	1.005	1.100	0.970
7	1.006	1.150	0.960
8	1.007	1.100	0.970
9	1.008	1.200	0.960
10	1.008	1.250	0.950
11	1.008	1.225	0.940
12	1.009	1.200	0.950
13	1.010	1.200	0.940
14	1.011	1.225	0.930
15	1.012	1.240	0.920
16	1.011	1.100	0.910
17	1.011	1.225	0.930
18	1.012	1.250	0.920
19	1.013	1.225	0.910
20	1.014	1.250	0.900

Source: Artisan Partners. For illustrative purposes only.

Exhibit 2: Illustrative Stock Performance



Source: Artisan Partners. For illustrative purposes only.

Some of the more mathematically inclined among you may attempt to calculate the standard deviation of returns and rank the securities based on that metric. We will save you the trouble and offer that data in Exhibit 3.

Exhibit 3: Standard Deviation of Illustrative Returns

A	B	C
0.057%	6.853%	1.005%

Source: Artisan Partners. For illustrative purposes only.

Based on the numbers in Exhibit 3, would it be fair or right to say that B is substantially riskier than a money-losing proposition, C? Your answer may well not align with that one metric.

Some of you may even say, "Wait, risk compared to what?" as is the norm for financial markets analysis.

For the next exercise, let us assume that A is actually the market/index and B is a concentrated portfolio of idiosyncratic and attractively priced securities at a deep discount to fair value. In this instance, a traditional beta of B to A is well north of one and may encourage many to view B as a much riskier proposition.

Hold on to that thought as we make just one tweak for the last exercise. For this part, assume C is the performance of the market/index while B remains the portfolio under our review. Suddenly, based on the traditional beta, B is less risky than the market (in this case, C).

Note in our last two exercises the performance of B did not change. Only the relative index/benchmark and its performance—over which an investor has no control—changed.

The point is that reliance on a handful of mathematical or financial metrics to capture or quantify risk may not lead to the right answers and can potentially engender complacency and a misplaced sense of security.

So, what do we view as risk?

We view risk as the potential for permanent loss of capital. For us, risk is not volatility or deviation in performance—over or under—from any benchmark. We like volatility as it gives us an opportunity to get involved with good franchises due to temporary mispricing and the mood swings of Mr. Market. For all the complaints of irrationalities in the market, if Mr. Market were truly rational all the time, yours truly and many peers would be out of a job.

With that focus on capital preservation, in no particular order, the different types of risk we think of when selecting investments and managing our portfolio are as follows:

- Macro—Many external risk factors belong in this category, including inflation, volatile commodity prices and supply chain disruptions. We try to mitigate these risks by focusing on good business franchises with some moat. These businesses often have pricing power and are able to pass on price hikes to protect their profits, if not the optical margins.
- Domicile Differential—While we expect good franchises run by sensible management to flourish in most economic environments, we also pay attention to where our companies are domiciled and operate. We would like these countries to have reasonable balance sheets and fiscal budgets, sensible leadership and offer fair protection of property rights for international investors in their local jurisdictions.
- Capital Misallocation—Management, along with the board, determines how capital generated by the business is allocated, and value can be destroyed by reckless capital allocation. By focusing on companies with good management teams, we can potentially not only offset this risk but also benefit from additional value creation through disciplined capital allocation.
- Alignment—We look for businesses with sensible owner-operators and instances where management's incentives are aligned with those of minority shareholders. This reduces moral hazard risk and keeps management focused on being nimble to address challenges in the market, such as supply chain disruptions and geopolitical issues.
- Liquidity—Rising interest rates and declining credit availability have highlighted the value of liquid balance sheets. By focusing on companies with strong balance sheets, we are able to sleep peacefully knowing they are more likely to not only survive a liquidity crunch but also potentially thrive in such environments by competing aggressively as levered competitors struggle to survive.
- Valuation—A normalizing interest rate environment is likely to lead to a normalization in the cost of capital and the valuation multiples for companies. By always using a normalized cost of capital and taking a "through the cycle" view of the earnings power of a business, we are not swayed by valuations benefiting from short-term or cyclically depressed expense line items such as credit costs. Being stingy on the prices we pay and looking for a margin of safety can potentially give us some downside protection even if there is multiple compression and some of our assumptions are off.
- Dilution and Over-Diversification—As disciplined investors, our goal is to identify a range of idiosyncratic investment opportunities with asymmetric risk-reward profiles. While we do construct our portfolio to have the potential benefit of diversification across different parameters, we remain benchmark agnostic and avoid diluting the impact of our convictions. Consequently, our portfolio is focused with just 30-40 stocks. We realize that the active share and tracking error of our portfolio will likely remain high, but we consider this to be a desirable feature of our process rather than a flaw.
- Duration and Asset/Liability Matching—A mismatch in expectations between capital providers and investee companies can result in material value destruction. We take a "through the cycle" view of the earnings power of our businesses, and our average expected holding period is three to five years. We emphasize this to portfolio companies as well as current and potential investors as we do not want mismatched expectations adversely impacting our investment process and introducing additional risk.

Lastly, we attempt to avoid stacking up different—even if sometimes uncorrelated—risks as they can lead to binary outcomes. For example, think of a commodity producer with a volatile earnings stream (a price taker with commodity price risk) with a substantial fixed-cost base (operating leverage) and debt on the balance sheet (financial leverage). If you get it right, it can be a massive multibagger, but if not, it can lead to a complete and permanent loss of capital. A substantial portion of our personal savings is invested alongside our investors' capital, and gambling with anyone's hard-earned money is bête noire to us.

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