GREENWOOD REPORT

ON RISK AND VOLATILITY

With the recent volatility in the global equity markets, the subject of "risk" has re-emerged as a leading conversation topic among the media talking heads. **Mr. Market**[1], a metaphoric figure used to represent the collective opinions of global investors, is a fickle fellow. His mood changes on a whim: euphoric on some days and depressed on others. His optimism is contagious when all is well in the world but his pessimism takes hold at the slightest hint of distress. In a word, Mr. Market is manic and because his memory is short-term, he tends to make snap judgments. Risk-on, risk-off. Buy then sell. Play the game, sit on the sidelines. Such is the recipe for the current volatile environment. *Mr. Market senses risk, but he can't make his mind up on how to carry on.*

At Greenwood Gearhart Inc., we use this volatility as an advantage in our investment decision-making process. In our opinion, *volatility does not represent risk – it represents opportunity.* Every day we have the luxury of making decisions on individual investments based on our estimate of their intrinsic value, their individual risk characteristics, and their offering price in the market. An oscillating market affords long-term investors the *opportunity* to make buy and sell decisions at more or less attractive prices. As Warren Buffett says, we can pick the pitches we swing at.

Consider the eight weeks between April 29 and June 15. During this period, Mr. Market fell 7% as a result of higher gas prices, tensions in Europe, the disaster in Japan, and the slowdown in global manufacturing. Over these eight weeks certain companies fared much better than others. For example, Company A – a darling of Mr. Market's – held its ground and actually rallied through the pullback. Company B – the disdain of Mr. Market – fell twice as fast losing 15%. In this eight week period, neither company announced a major change in operations, a management change, a market exit, or a product recall. Their business fundamentals remained intact and their future prospects immaterially changed. Yet the companies had very different short-term results. Why?

Such is the heart of intelligent investment. At Greenwood Gearhart, our assessment of risk is not based on volatility in the market but rather on individual company fundamentals. We especially like the out-of-favor Company B's. We intelligently assess the risk of each company and form opinions irrespective of manic Mr. Market. When we do this well, we are more willing to purchase Company B when Mr. Market offers it at $85 a share than at $100 a share – even if other less informed practitioners deem it more risky due to its volatility[2]. To us, it is counterintuitive to shun good companies when they are on sale – who doesn't like a sale after all? Currently, we are spending our days searching for Company B's and assessing if any Company A's in our portfolios are candidates for profit taking. Your quarterly reports will convey our decisions.

For the remainder of 2011 (and beyond), one thing we can count on is continued uncertainty – it is ever-present. A number of scenarios should continue to put pressure on the broader market, making our job of navigating the waters more opportunistic and perhaps more difficult. As our long-term clients have heard us say time and again: *Investment is placing capital at risk with the expectation of a gain, but the possibility of a loss. Risk is the uncertainty about which outcome will occur and the probability of loss when unfavorable ones do.* Our job as professional investment managers is to mitigate risk and enhance the probability that our clients achieve gains over long periods of time. We believe we have the ability to do this through hard work, superior knowledge, and diversification.

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Our **knowledge** tells us that there are still a number of investments available at attractive prices – albeit less than were available at the market lows of 2009. Determining which investments meet our criteria for purchase is hard work but a challenge we accept eagerly. We also believe that the macro environment is both challenging and uncertain. Knowing we can't time the market based on macro factors, we use our judgments on the global economy to inform our decisions at the company level. Absent a major shock in the form of a terrorist attack, nuclear disaster, or war, we still believe the economy is mending, even if at a slow pace.

We also mitigate risk through **diversification**. Appropriately diversified portfolios offer downside protection when unfavorable outcomes occur. Because we believe a consistent, long-term investment approach wins the race, we don't expect top-quartile results year-in and year-out. We believe even the lay investor has a 50% chance of top quartile performance by following a simple approach: use large amounts of leverage and concentrate investments. However, in any one year that investor could be either in the top quartile or out of business altogether (see the hedge fund industry). Our business has sustained for nearly 30 years because we avoid these pitfalls. We will continue to do so for 30 more.

At the same time, we monitor for over-diversification to ensure we are still able to *move the needle* with performance. By using individual securities we can monitor portfolios at the company level and avoid the over-diversification and over-lapping of holdings that is common with using third-party managers or mutual funds.

When you catch your mood swinging with the daily gyrations in the stock market, remember Mr. Market. Remember that his capricious behavior is an advantage to the long-term investor. Most of all, remember that intelligent risk management, diversification, knowledge, and a long-term approach wins the race.

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1. The term "Mr. Market" was coined by Ben Graham, the father of Value Investing, in his seminal work *Security Analysis*.
2. A reminder: there is no universal definition of risk. The academicians want you to believe that complex formulas backed by theory are proxies for risk. One measure in particular, standard deviation, indicates the volatility (they say risk) of a stock or portfolio. The theory suggests that the higher the historical volatility, the higher the standard deviation, and thus, the higher the risk. But this measure has little to do with the underlying fundamentals of the business. Standard deviation doesn't report on the quality of the company's management, the soundness of their business strategy or how many widgets were sold last week. Simply put, standard deviation is a measure of volatility. It assumes the market has perfectly incorporated all available information into a stock's price and that the stock's volatility is justified. It also assumes that market prices follow a normal, bell-shaped return distribution. The lessons from 2008-2009 remind us that markets can have *fat-tail* returns and are most certainly not normally distributed.