BARROW STREET
ADVISORS

Advisor Insights

Risk & Volatility

Contrary to popular belief are not synonyms.

As an investment manager Barrow Street Advisors is constantly evaluating the market and seeking opportunities which maximize its risk/reward ratio. From portfolio construction all the way down to security selection we strive to mitigate risk by purchasing a diversified basket of quality businesses at temporarily depressed prices.

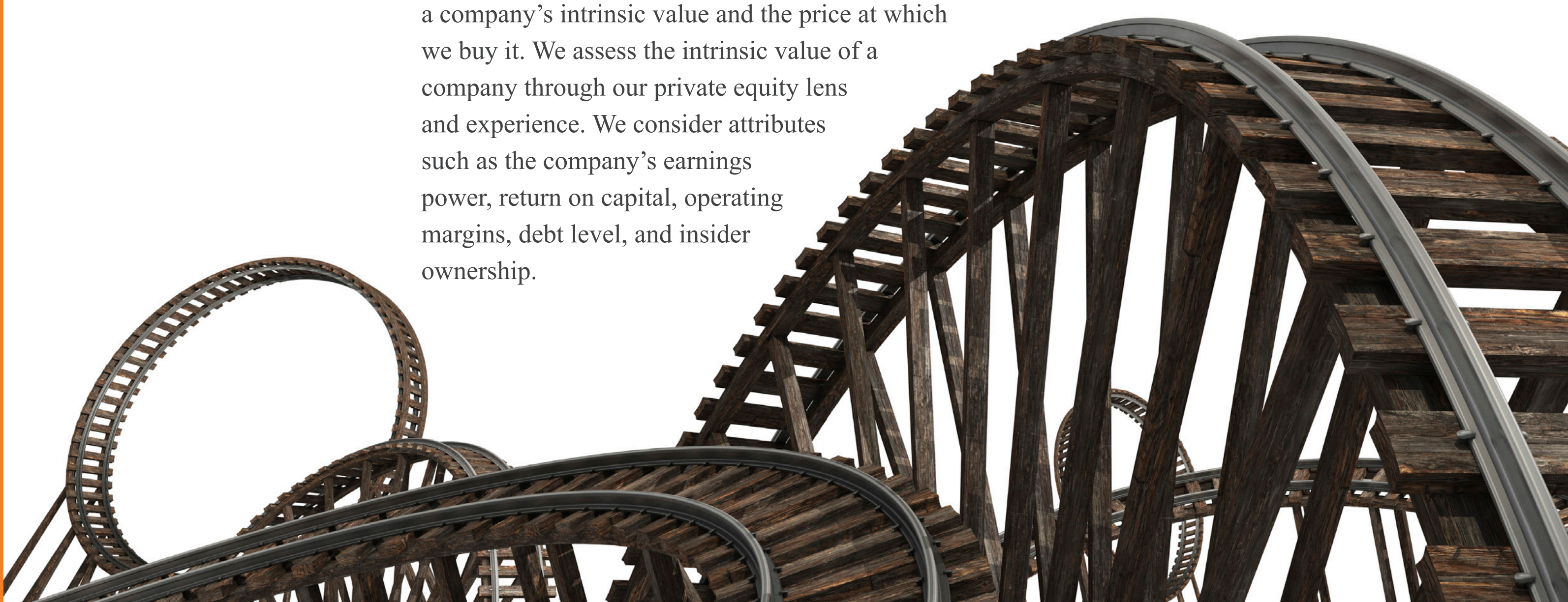
But what exactly is risk? In the world of finance, risk and volatility (volatility represented by standard deviation) usually go hand-in-hand. However at Barrow we argue against the widely accepted association between risk and volatility. While in the field of academia volatility is a neat and quantifiable way to define risk, at Barrow we see it differently.

Real Risk: Permanent Loss of Capital

At Barrow we believe risk is the probability of permanent capital loss, not volatility. In fact, volatility is the friend of intelligent investors who take advantage of irrational market behavior created by market swings. Permanent capital loss destroys wealth and the power of compounding. That is the risk we seek to avoid.

In our opinion, volatility does not hurt investors who are able to finish the roller coaster ride. Obvious benefits of volatility are the opportunity to buy assets at depressed prices and sell short assets at inflated prices. Volatility is certainly not the multi-headed Hydra that modern portfolio theory would have one believe.

Risk cannot be boiled down to a single number. At Barrow, we primarily seek to mitigate our risk, or permanent capital loss, by establishing what is commonly known as a "margin of safety" between a company's intrinsic value and the price at which we buy it. We assess the intrinsic value of a company through our private equity lens and experience. We consider attributes such as the company's earnings power, return on capital, operating margins, debt level, and insider ownership.



While establishing a margin of safety is most important, intelligent investors must demonstrate humility with sound portfolio construction, paying close attention to position size and industry diversification, ownership concentration, and liquidity among other things. At Barrow, we seek to “win” across a diversified group of investments in a well-constructed portfolio, much like a well-run insurance company. If one stock blows up for any reason we failed to predict, it may dent the hull, but we believe it will not sink the ship.

Margin of Safety

Risk becomes reality – and permanent capital loss – for investors without a margin of safety as they watch the market align a stock’s price with its intrinsic value over time. While we believe the market is irrational in the short term, it does tend to properly appraise a company’s value and price over time.

> *“In the short term, the market is a popularity contest. In the long term, the market is a weighing machine.” – Warren Buffett*

An investor’s real risk is the future probability and severity of permanent capital loss by buying an asset at pricing above intrinsic value (i.e with a negative margin of safety). With short selling, risk is the future probability and severity of capital loss when assets are sold short at pricing below intrinsic value.

Here is some simple math. If an investor buys a stock at a price of $100 and an intrinsic value of $75, he risks permanently losing $25. If an investor sells short a stock at a price of $75 with an intrinsic value of $100, she risks permanently losing $25.

Investors without a margin of safety ride the stock market rollercoaster with the sword of Damacles over their heads. Markets can be scary enough on their own – why add to the risk by failing to build a margin of safety into your portfolio?

Volatility

Volatility leads investors to panic and suffer permanent capital loss because they cannot manage their emotions. At Barrow, we employ a disciplined, rules-based investment process that does not make investment decisions based on the whims of human emotion. We seek to take continual advantage of market participants’ irrational behavior, which enables us to buy stock long and sell stock short at prices well below and above intrinsic value, respectively.

Many analysts are often misled with a false sense of security from looking at historical volatility. Volatility is backwards-looking and therefore cannot give one a sense for how a portfolio or security will perform in a future challenging environment. Relying on volatility to make investment decisions can lead to a great deal of trouble and complacency.

Not all price movements are equal. Volatility takes into account deviations both above the average return and below the average return. The most popular measure of volatility – annualized standard deviation of logged daily price returns – does this. At Barrow, we are concerned about downside volatility, not upside volatility - which we desire.

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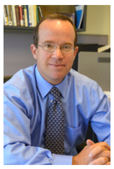
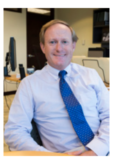
Barrow Street Advisors Leadership

Nicholas Chermayeff
Principal
- 24 years of industry experience
- BA Harvard College



Robert F. Greenhill, Jr.
Principal
- 25 years of industry experience
- BA Harvard College
- MBA Harvard Business School



David R. Bechtel
Principal
- 25 years of industry experience
- BA Yale University
- JD Stanford Law School

About Barrow Street

Barrow Street Advisors LLC is a registered investment advisor and is an affiliate of Barrow Street Capital LLC which is an investment management firm that manages value-oriented private and public equity strategies.

Headquartered in Stamford, CT the firm serves pension funds, sovereign funds, endowments, foundations, family offices and high net worth individuals. Since its inception, Barrow Street Advisors LLC and Barrow Street Capital LLC have invested approximately $550 million, cumulatively, of equity in private and public equity strategies.

For More Information

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Along these lines, we find the Sortino Ratio and Calmar Ratio to be the most relevant statistical measures of downside volatility. The Sortino Ratio divides an investment's average return by its average downside deviation. The higher the ratio, the better. (Average downside experience measures *average angst,* but as we laid out before, not necessarily risk.) The Calmar Ratio divides average annual return by the maximum drawdown over a given period. Quite different from the Sortino Ratio, the Calmar Ratio measures the amount of return per the *worst* point-in-time cumulative downside experience.

$$\textbf{Sortino Ratio} = \frac{\text{Total Return - Risk Free Rate}}{\text{Downside Deviation}}$$

$$\textbf{Calmar Ratio} = \frac{\text{Avg. Annual Compounded Return}}{\text{Max Drawdown}}$$

Volatility Can Mean Opportunity

Separating true risk (capital loss) from volatility drives a large part of our portfolio construction and security selection. In seeking to avoid confusing risk with noise (price volatility), we focus on business fundamentals, intrinsic value, and market pricing. The confidence we thus gain, allows us to stick to our investment discipline and continue to buy quality businesses at attractive prices during periods of high market volatility, giving us some of our best entry points.

Diversification Reduces Risk

We believe risk of permanent capital loss is reduced by diversification. For example, if one purchases long an equal amount of two uncorrelated assets each at average pricing of $100 and average intrinsic value of $75, the future risk of capital loss is $25. However, the risk of losing $25 in both assets is less than if all the capital had been invested in just one of the two assets. Why? The market pricing and intrinsic value of different assets will always converge and diverge differently with respect to timing and degree. Diversification reduces risk.

The Way to Go

In our opinion investment strategies with a margin of safety and ample diversification are the way to go. Intelligent investors can be rewarded greatly for withstanding volatility if they are investing with a margin of safety to reduce the risk of permanent capital loss. For those who wish to reduce volatility while still earning an attractive equity-like return, alternative long/short investment strategies may be the way to go.