QV UPDATE
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What is risk?

More than ten years after the Global Financial Crisis the U.S. equity market remains in a bull market phase despite mounting evidence that the current global economic expansion is facing an increasing number of headwinds. Some have suggested that the recent spike in stock market volatility is indicative of a *riskier* environment for equity investors – driven by growing unease around the sustainability of the current economic cycle. For fundamental investors, understanding the sources and drivers of risk, and ultimately seeking adequate compensation for the onboarding of risk (in the form of expected return) should form the basis upon which most investment decisions are made. If risk is properly assessed and understood, it need not be minimized but can be optimized to produce desired results.

What is risk? The Merriam Webster dictionary defines risk as "the chance that an investment (such as a stock or commodity) will lose value." For many individual investors, risk is consistent with this definition and is characterised as the likelihood of permanent impairment of their capital. However, academia and many in the investment industry define risk as the volatility of share price returns – which can be measured by both beta (measure of systematic risk) and standard deviation (measure of total risk). Stocks exhibiting higher volatility are deemed to be riskier relative to stocks with comparatively lower volatility. Unfortunately, volatility conveys nothing about the value drivers of a business, nor does it convey the likelihood of intrinsic value impairment (i.e. permanent impairment of capital) resulting from the deterioration of these value drivers. If the fundamental attributes of a business (earnings, cashflow, returns on capital, etc.) ultimately underpin its intrinsic value – how can its riskiness be determined by statistical measures of historical volatility? Risk needs to be assessed by gaining a better understanding of the underlying business and this can be best accomplished through bottom-up fundamental analysis. Legendary investor Warren Buffett effectively echoed these views when answering a question on volatility during Berkshire Hathaway's 2007 annual general meeting: *"Volatility is not a measure of risk…risk comes from the nature of certain kinds of businesses…if you understand the economics of the business in which you are engaged, and you know the people with whom you're doing business, and you know the price you pay is sensible, you don't run any real risk."*

When assessing risk through the likelihood of intrinsic value impairment – there are generally three overarching risks that equity investors should consider: *operational risk*, *financial risk* and *valuation risk*. Operational risk encompasses a series of internal factors (operations, processes, people) and external factors (industry, competition, economic, political) which can impact the operating results of a business and adversely affect its profitability and cashflow. Financial risk is largely a bi-product of capital structure and is often proportional to the level of debt on a company's balance sheet. It represents the likelihood that a company's cash flows will be insufficient to service and meet its financial obligations. Valuation risk represents the risk of overpaying for a business or receiving less than anticipated for it upon its disposition. Experienced management teams can mitigate some of these risks, but many are unavoidable and are simply a defining characteristic of the underlying business.

Shares of Novo Nordisk A/S (NYSE: NVO) were recently added to QV client portfolios, partly based on these risk considerations. NVO offers defensive operating characteristics, industry-leading returns on capital, minimal financial risk and a reasonable valuation. The company's history of consistent R&D investment and product innovation have made it the global leader in diabetes care. NVO remains well-positioned to grow intrinsic value from current levels.

Although constructing portfolios exhibiting low volatility may be desirable for some investors – risk is ultimately a function of underlying business attributes which can only be uncovered through proper due diligence and homework. Risk should not be confounded with volatility of returns. In his book One Up on Wall Street, Peter Lynch famously penned *"Know what you own, and know why you own it."* This is central to understanding risk. Unfortunately, beta does not get you there.