

## INVESTMENT

# The 'real' risk in equity

Risk lies neither in price 'volatility' nor in any fancy statistical descriptions. It lies in not knowing what one is doing

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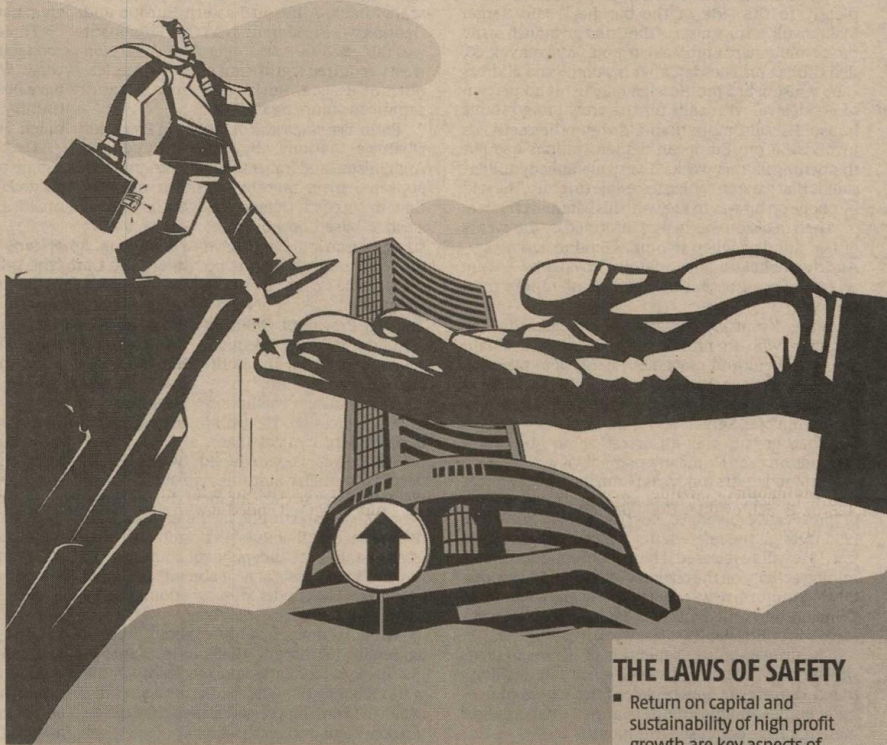
The real risk in investing is only one: not knowing what one is doing. Not knowing the character of the business (return on capital employed, size of opportunity, earnings growth predictability, sustainability, durability, etc) you are investing in, not knowing the quality of the management (integrity, intellect, vision and execution capability), not knowing the real intrinsic worth (as distinguished from the price) of the business, and not having the discipline to act on what you believe you know. If you know all these, there is no real risk in equity investment. Even if some stocks do not turn out well, the overall portfolio will. There is a deeply entrenched feeling in the minds of investors that low risk correlates with low returns and high risk with high returns. Probably nothing is farther from the truth. In my book *'Of Long-Term Value & Wealth Creation from Equity Investing: Observations, Ideas and Reflections'*, I have dealt with these concepts and misconceptions of equity investing.

### Redefining risk and return

Unfortunately, classrooms and textbooks too teach and perpetuate such untruths. Empirical evidence reveals the exact opposite. Ultimately, what is risk? Is it really the deviation of price from real value? Or is it in not knowing where lies the real value?

Key components of the risk-return equation are: One, what is the real value? Two, how far has price veered from the value? Three, comprehending the psychological behaviour (rational/irrational) that merely the fact of (price) deviation elicits even if the value remains unaltered. Four, having mental resolve, discipline and wisdom of acting rationally. Behavioural economics suggests that psychologically, the higher the price, the lower the demand and vice-versa. But, interestingly, in investing, when the price of a stock is high and going up, demand (for the stock) goes up and demand stumbles when the price falls.

This may sound contrary, if not downright perverse, but is true. If you know the real value of a stock and do nothing irrational about the volatility, there is no real risk. The risk comes when you act on (price) volatility rather than on what you know (value of the business). If the real value of a business is, say, ₹100 and the price is ₹80, the margin of safety is 20 per cent and the implied



one-time returns are 25 per cent (plus the annual returns represented by the time value of money or the discount rate applied for value computation).

Now, if the price drops from ₹80 to ₹60, the margin of safety improves from 20 per cent to 40 per cent and the implied returns actually go up to 67 per cent. If you own the stock, your immediate psychological reaction would be to see the falling price as a risk. But in reality, risk has shrunk (not increased) with improved margin of safety and returns have increased (not declined). However, rationality can and does get frightened by psychological reactions. Fear, greed and hubris interfere to prevent even intelligent minds from taking rational decisions.

### Asset class risk is not the same

The broad equation of low risk and low return probably applies to asset classes per se, but not to a security selection within an asset class. Generally speaking, a sovereign bond will have a lower risk and lower return than, say, a fixed deposit with a commercial bank,

which carries higher returns and higher risk.

On similar lines, equity as an asset class may appear a riskier asset and is expected to produce higher returns than sovereign bonds or fixed deposits. So, the aphorism applies broadly to asset classes among themselves, but unfortunately, is made applicable even within an asset class. Within an asset class, it is only low risk that can produce higher returns. Hence, one can't hope to achieve higher gains by indulging in aberrant and reckless behaviour. Even if one succeeds, it will be episodic and not a replicable way of successful equity investing.

### Efficiency of capital is key

Returns are tangible, risk is not. Hence, returns appear real to investors, but risk seems to be illusive. This is where the concept of quality of returns arises. The quality of a business, simply speaking, is its ability to generate superior, consistent, predictable and durable returns on capital employed (RoCE).

The returns are superior for companies with a high RoCE and high earnings growth. These are busi-

### THE LAWS OF SAFETY

- Return on capital and sustainability of high profit growth are key aspects of equity investing
- Acting on price volatility and ignoring the fundamental value of the business is detrimental
- A growing business has to be available at a value price for it to create investment returns
- Never act on a purchase decision until a favourable price turns up, offering sufficient margin of safety

nesses with both strength and character, leading to high and sustained value creation. Superior RoCE protects value while earnings growth expands value. Businesses with a high RoCE and low or no earnings growth are at best a recipe for maintenance and preservation of capital, but not for expansion. Plunging earnings can actually lead to value destruction despite a high RoCE.

A combination of poor capital efficiency and low growth doesn't even merit discussion. If capital efficiency is persistently lower than the cost of capital, high earnings growth would actually be value destructive rather than pro-

ductive. Value and growth are two sides of the same coin. Many a time, we try to distinguish between growth and value as if they are two different matters.

If a business has to have value, it has to be growing. And a growing business has to be available at a value price for it to create investment returns. Ultimately, the investment game is simple, but not easy. It is simple because the fundamental principles are simple to comprehend; the task is really to identify a quality business (large opportunity, superior RoCE and durable/decent earnings growth) run by a quality management, to have the capability to value the business, and then set a target for a purchase price (at a discount to the value).

Never act on the purchase decision until a favourable price turns up, offering sufficient margin of safety (so as to adequately cover possible errors of judgement of value and the possible short-term risk of the price not behaving in the expected way) and sit out patiently on the position without losing one's perspective. This is the game. Principles are simple. Discipline of doing it is not. Investors get obsessed about valuing the price, rather than pricing the value.

### The path of quality returns

Now, where to discover that value? There is significant value in select agri nutrients and farm-related businesses. Similarly, select banks and non-banking financial firms have outstanding capital efficiency, low bad loans and attractive valuations. A few quality capital goods firms with low debt and select logistics firms also have significant value and quality earnings potential. Many auto and auto spare parts businesses offer quality and value.

Though it may get contested, yet many high-quality consumer and pharmaceutical firms still offer value given their strong earnings growth potential. Firms enjoying a high RoCE and high growth should logically create high value. Over FY03-12, companies with high core RoCE (above 20 per cent) and high annual growth (over 15 per cent) of profits had compounded annual investment returns of 33 per cent. There are 97 firms in this category and names like Blue Dart, ITC, Pidilite, Marico, Shree Cements, Sun Pharma, Lupin, Nestle, Hero MotoCorp, Motherson Sumi, Asian Paints, GRUH Finance, HDFC, Thermax, Cummins, etc, fall in this list.

What is noteworthy is that this group of winners has been able to generate positive annual returns of 12 per cent, even during the most difficult period of 2007-12. This is the place to find multi-year compounding machines which offer great safety and yet good returns, even during fabled times.

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