Understanding Risk

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Some of the primary goals of investing are maximizing returns and controlling risk. Managing these two often competing goals is essential for building wealth and protecting portfolios from permanent capital loss. Investing always deals with estimating future outcomes, and the variability of those outcomes enhances risk.

Risk is present in bull markets, but it generates the most investor concern during tough times. Protecting portfolios from unexpected events is important to survive periods of high volatility. As Warren Buffett famously said, "Only when the tide goes down do you discover who is swimming naked."

So, how does one limit exposure to uncertainty? The core premise of Exencial's SELECT strategy is to control risk. The term for this analysis is risk/reward. Each company selection is deeply researched for downside risk, financial strength, management capability and competitive advantage. We understand that the future is impossible to predict, but we strive to always be prepared for market downturns as well as increases.

As we study hundreds of companies, only a few earn our designation of SELECT. We believe market leaders typically generate the greatest profitability. Examples include Facebook, United Parcel Service, BlackRock, Disney and Colgate. We also prefer companies with strong balance sheets. That means, in addition to maintaining superior profit margins, they usually have modest debt levels and strong cash positions that help them stay the course during recessions.

We focus on industries within key business sectors that generate consistency of return over full business cycles. For instance, within the technology sector, we prefer software and service companies over computer hardware and semiconductor manufacturers that are very sensitive to economic changes. Within industrials, we like diversified product companies, such as MMM and Johnson Controls, over metals and building product manufacturers that tend to wilt quickly during slowdowns. Finally, in consumer cyclicals, we favor restaurants, athletic shoe manufacturers and entertainment content providers over auto manufacturers, airlines and homebuilders that often require long uninterrupted stretches of growth to prosper.

The bottom line is we are very careful in our investing decisions and favor certainty, consistency and financial stability over trying to capitalize on volatility. This means there are periods in a bull market when investors that choose to concentrate in high-growth areas or be more speculative may generate higher returns than the SELECT strategy. When airlines are suddenly filling their planes, home construction is surging and semiconductors are in demand, their stocks will usually take off. On the other hand, the reverse occurs when business activity slows or markets become volatile incorporating new and different economic information.

We'd rather own companies that make solid progress in good economic times and weather slow or negative economic growth without suffering debilitating setbacks. In our experience, over entire business cycles, these companies will be able to generate above-average profit margins and good, sustainable returns for investors. This is the risk/reward profile we find compelling.

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