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Wealth

Buy prudently and be a fan of fear to reduce risk

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While everyone would agree it makes a lot of sense to prepare one's portfolio for mistakes, bad luck or cyclically difficult times, most investors devote too little attention to risk management.

When times are tough, an emphasis on damage control can overshadow the more prudent weighing of risks versus rewards. When times are good, a false sense of security dulls the attention paid to what can go wrong.

"Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favourable business conditions," wrote Benjamin Graham in The Intelligent Investor. "The purchasers view the current good earnings as equivalent to 'earning power' and assume that prosperity is synonymous with safety."

In the hedge funds I co-manage, we seek to mitigate risk in difficult times, such as today, in three primary ways: increasing our short exposure; only bottom-fishing for out-of-favour stocks when we are certain they are trading at enormous discounts to intrinsic value (at least 50 per cent); and buying stocks of businesses we think are insulated from the current weak economic environment or, better yet, will profit from it.

It's hard still to recommend shorting the stocks I highlighted in my mid-April column, in which I wrote: "Funds I co-manage remain short MBIA, Ambac, Washington Mutual, Lehman Brothers and PMI Group, among others, believing that each faces substantial loan writedowns in excess of what the market is expecting."

In a mere two-and-a-half months, these five are down an average of more than 60 per cent. Our largest short position today is credit-ratings company Moody's, which we think is trading at a too-high multiple (nearly 18 times) of too-high consensus 2008 earnings estimates ($1.93 a share), given the strong headwinds the company faces. Much of its large and highly profitable business of rating structured-finance products is likely gone forever, while investors' confidence in its ratings has been impaired.

A good example of a stock in an out-of-favour sector that's way too cheap is Barnes & Noble, which trades at a five-year low and is down 15 per cent since I recommended it in mid-March. It was cheap then and it's even cheaper now – and the company and chief executive Len Riggio have been taking advantage, buying back a combined 14 per cent of the company's shares in the first quarter alone. We expect Barnes & Noble to earn $380m in earnings before interest, taxes, depreciation and amortisation this year, with free cash flow of about $190m. With the stock just above $24, it trades at only 3.6 times ebitda on an enterprise-value basis and 6.9 times free cash flow, for a cash flow yield of 14.5 per cent. We think a private buyer would pay double these multiples for this high-quality business.

Finally, Fairfax Financial and Berkshire Hathaway are good examples of companies I've written about before and continue to think are well positioned to profit from the continuing credit crunch. Fairfax has an enormous portfolio of credit default swaps on various distressed financial companies, which we think increased in value by at least 25 per cent in the second quarter. This should drive a double-digit increase in Fairfax's book value during the quarter. Nevertheless, the stock fell 12 per cent during the quarter and now trades at a discount to book value.

Berkshire's stock has also been weak, yet the company has one of the strongest balance sheets in the world and it would not surprise me if Warren Buffett used it to make a very large investment in a distressed financial institution on extremely attractive terms. Incidentally, Buffett making such an investment would probably be a good sign that financial stocks have bottomed. His shunning of investments in the sector to date indicates he believes there is more pain to come.

A further way to mitigate risk is to simply not invest at all and hold cash until a sufficiently attractive risk-reward opportunity presents itself. As Buffett says, there are no called strikes in investing. We are not holding much cash today because we're finding some outstanding buying opportunities, but staying on the sidelines out of fear is nothing to be ashamed of.

As Baupost Group's Seth Klarman, who has had only one down year since inception 25 years ago, counsels: "We are big fans of fear, and in investing it is clearly better to be scared than sorry."

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