



RISK AND VOLATILITY

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Many otherwise savvy investors do not understand the difference between risk and volatility. Their perception is that an investment with above-average volatility must be accompanied by above-average risk, which isn't necessarily true. Being able to distinguish one from the other is important.

For example, like most people, you probably consider government bonds risk-free. After all, the US government has never defaulted on its debt. Buy a 10-year Treasury bond today and you are guaranteed to get your money back in 2010. No risk, no volatility, right? Wrong.

Suppose you purchase a 10-year Treasury bond issued 3 years ago that has 7 years until maturity. The coupon is 3%, but since issuance interest rates have risen from 3% to 6%, the bond has depreciated from \$1000 to \$820. The bond's volatility makes it appear risky- after all, it has depreciated 18% in just 3 years. But in this case, the volatility does not entail risk if your investment horizon matches the bond's maturity date, since the government guarantees its value at maturity. The volatility could involve risk for someone forced to sell the bond before the maturity date.

Market Uncertainty

A related and equally important consideration is uncertainty. The markets hate uncertainty and, more often than not, can't differentiate uncertainty that includes risk from uncertainty that does not.

As an example, let's assume a company is considering a dividend increase on its stock over the next 30 days. Your analysis tells you the stock is fairly priced at its current dividend rate. A dividend increase will make the stock worth more, and without a dividend increase the stock will be worth its current prices. As the date for the dividend declaration grows closer, the stock sells off due to uncertainty about the dividend increase. Knowledgeable investors will take advantage, realizing there is no risk, only uncertainty. The uncertainty is that as a physician-investor, will you get your current dividend and have a fairly devalued stock, or will your stock increase its dividend, appreciate in value, and increase its cash flow? This is a heads you win, tails you don't lose situation. There is a significant amount of uncertainty, yet no real risk.

Here's a simple comparison of uncertainty and risk. If you flip a coin one hundred times- heads you get \$1, tails you get \$2- there is plenty of uncertainty but no risk. Either way you will come out ahead. The 2004 presidential election also illustrates this point. Before the election, the markets were directionless and displayed exceptional instability. As soon as we had a winner, the markets stabilized and took off because the doubt was resolved. The risk remained but the uncertainty was gone.

A real-life example is HealthSouth, where criminal and regulatory investigations created great uncertainty and volatility, like a mini-Enron. However, there is one major difference between the two. HealthSouth has hard assets, such as hospitals and the like, worth triple its liabilities. There was doubt about when investors would be paid, but not if they would be paid. Investors recognized this and bought HealthSouth bonds for as little as 5 cents on the dollar. In less than a year, they were repaid 100 cents on the dollar with 3% interest to boot. There

was uncertainty and volatility, but no real risk. The company's profitable hospitals and medical facilities backed up the bond's return of capital by more than 300%. Investors unable to distinguish between uncertainty and risk were forced to prematurely liquidate their positions. Their perception of HealthSouth was distorted by the previous but very different circumstances at Enron and MCI.

Hedging the Risk

The HealthSouth example is not an uncommon one. The hedging strategy used plays against the inherent volatility or uncertainty of a market or industry. There remains a misconception among many otherwise savvy investors regarding hedge funds. Most people probably still regard hedging as a high-risk strategy. Of course, there are many different methods of hedging, but the industry as a whole has been saddled with a shaky reputation because of the perennial few bad apples, such as the Long-Term Capital Management blow up in 1998. The publicity from such an event skews overall market perceptions while most hedge fund managers, among the smartest and most sophisticated asset managers in the financial community quietly continue to earn good risk adjusted numbers for their investors.

Volatility is one of the primary drivers of hedging strategies. Hedge fund managers typically rely on the constant movement of equities to provide opportunities for enhanced investment performance. The volatility provides the performance opportunities, but the risk is minimal for physician-investors with sufficient time horizons, assuming you have an experienced and competent financial advisor.

In a risk-adjusted hedging strategy, physician-investors may invest in a stock at \$100 a share because we believe it will be worth \$125 a share over the coming 12 months. Investors also buy a put at 95, so if some unforeseen event occurs (e.g. A terrorist attack, oil embargo, the CEO's place goes down, etc) and the stock drops to 30, you only participate in the drop down to 95. The strategy limits your exposure to a 5% risk, while leaving the \$25 upside intact, regardless of how much uncertainty or volatility to which that stock may be subject.

So while uncertainty and volatility are predictable and omnipresent in the markets, risk can be defined and controlled. Understanding the difference between risks and volatility can mean the difference between investment gain and loss. Investing fundamentals don't change.