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Resources Management Corp

MARKET COMMENTARY

ASSESSING RISK

John Kenneth Galbraith once stated that "there are two kinds of forecasters: those who don't know, and those who don't know they don't know." In the process of evaluating the multitude of investment opportunities that the market presents us with on a daily basis, we must necessarily consider what the future holds for each company. Far too often, however, investors and speculators alike get caught up in the delusion of "false precision." While a keen understanding of a company's sensitivity to the drivers of growth, value and secular shifts is inherent to any successful investment operation, the outputs of detailed financial models frequently get mistaken for facts, disregarding their limitations. In today's uncertain market environment, it is especially important to consider more fully all possible macroeconomic and company specific outcomes when analyzing the securities. From interest rates to earnings expectations, investors would be wise to weigh the probabilities and potential impact of a variety of scenarios rather than becoming fixated on what their model suggests as a sure future.

Within the world of investing, information about the future can be classified into three distinct categories: the important and knowable; the important and unknowable; and the unimportant. As it relates to the vast majority of forecasting, much time is spent "figuring out" the future of the important and unknowable category. Rather than attempting to precisely predict the exact nature of the future, it is far more prudent to weigh the complete spectrum of possibilities to understand what the impact on a particular investment would be. One obvious example of this relates to interest rate increases by the Federal Reserve. Many experts purport to know the number and timing of these rate increases over the next year, and they have adjusted their investments accordingly. This approach can prove to be effective if their assumptions are correct, but even the most astute forecaster lacks a true crystal ball. Not even Janet Yellen can say with certainty what interest rates changes may occur this year, and as such, investors should shift their focus to constructing a portfolio that is not solely dependent on consensus expectations of these changes.

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Benjamin Graham rightfully defined a true investment as an asset which "upon thorough analysis, promises safety of principal and a satisfactory return." Financial bets based upon "certainty" surrounding one particular outcome do not adequately meet the standards of an investment in that they do not promise the safety of principal that belongs as the foremost requisite for consideration as an investment. While returns should certainly be top of mind when managing a portfolio, risk management has long proven to be the primary key to realizing adequate gains over the long term. Viewing risk as the potential for the permanent loss of principal (as opposed to volatility, the most common proxy for risk) forces an investor to consider the impact that all possible versions of the future could have on a portfolio. The purchase of a security becomes speculation when the realization of value is completely dependent on a particular assumption or outcome. Irrespective of how certain an outcome may appear (in 2005 "housing prices always rise" was added to the catechism), forecasting should always be used as a tool to understand sensitivities rather than as a pursuit of a certain answer.

In a political and economic environment that is categorized by uncertainty, it is important not to get caught up in any one assumption about changes to fiscal and monetary policies. As we continue to consider the future of the market, RMC's focus is on weighing the impact of a wide range of policy changes as they relate to our investments. By searching for investments that can succeed in a variety of scenarios and are not reliant on any one particular outcome, we aim to achieve safety of principal and a satisfactory return profile.

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