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INVESTMENT COUNSEL

GLOBAL SMALL CAP SPECIALISTS

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"Volatility is often a symptom of risk but is not a risk in and of itself. Volatility obscures the future but does not necessarily determine the future." – Peter Bernstein

This year, the concept of "risk" has sparked significant debate in the industry. At Laurus, we define risk as the permanent loss of capital. However, perspectives on risk vary widely. Some associate it with volatility, as seen in the current year's market fluctuations. Others see risk in terms of liquidity, concentration (e.g., the dominance of the "Magnificent Seven" comprising over 25% of the S&P 500 Index), interest rates, inflation, and currency fluctuations—particularly considering the upcoming U.S. elections on November 5th.

As we discussed in our previous commentary, one of the greatest risks to investors is noise. Market forecasts, stock recommendations and their oft-times sensationalized return expectations come with an underlying agenda. The motives behind these narratives—whether selling a story, a product, or even influencing a vote—are crucial to understanding the source of the noise. As we've reiterated, the origin of noise is often linked to the promotion of whatever the noisemaker intends to sell.

Market pundits frequently discuss cyclical risk. While it's true that industries like energy, mining, and agriculture are highly cyclical due to their dependence on underlying commodity prices, most industries do not exhibit such pronounced cycles. Technology serves as a prime example: despite macroeconomic conditions influencing the pace of technological adoption, we're unlikely to revert to outdated technologies such as flip phones or MS-DOS. The developments in technology are largely secular rather than cyclical.

Small-cap investing is often shunned due to concerns over price volatility. However, historical data shows that emerging markets, small-cap, and mid-cap stocks have yielded the highest compounded returns. Naturally, these investments come with increased volatility, which is the trade-off for the potential of higher returns.

Private equity (PE) funds are often marketed as having low volatility, despite investing in assets like those found in small-cap funds. The leverage employed in PE fund acquisitions can enhance returns when interest rates are low. However, with current higher interest rates, a larger portion of cash flow is directed towards debt servicing, reducing returns to equity holders. The apparent lower volatility in PE is largely due to the absence of daily pricing by Mr. Market.

Diversification across multiple asset classes is key to achieving reliable returns. While this approach may not yield the highest returns, it generally results in the most consistent (or least volatile) performance. However, effective diversification requires a deep understanding of asset classes and their return correlations. For instance, relying solely on return correlations for equity indices can be misleading. The S&P 500 Index, for example, has been disproportionately influenced by the surge of the "Magnificent Seven," whose future returns may not replicate their past decade's performance.

This brings us to the role of passive versus active investing. Can active management truly add value compared to an index? According to a report by S&P Dow Jones Indices LLC, the majority (86.6%) of active U.S. large-cap managers underperformed the S&P 500 over the five- and ten-years ending June 30, 2023. This underperformance is likely due to the reluctance of active managers to allocate a significant portion of their portfolios to just a few stocks, thereby exposing themselves to concentration risk. In contrast, only 56% of small-cap funds underperformed the S&P SmallCap 600 Index over the same period.

One of the most significant risks in investing is behavioral. Investors are often driven by emotions, particularly risk aversion when underperforming. Howard Marks aptly noted, "*There's no such thing as a market...All there is, is people. And people have feelings. And so the emotions tend to get people to buy, buy, buy at the top... and sell, sell, sell at the bottom...*"

Risk, like beauty, is in the eye of the beholder. Yet, to rephrase Bernstein above, volatility is simply a symptom of risk. Any investment, public or private, should be considered after acknowledging the degree of underlying risk expected to achieve the return.