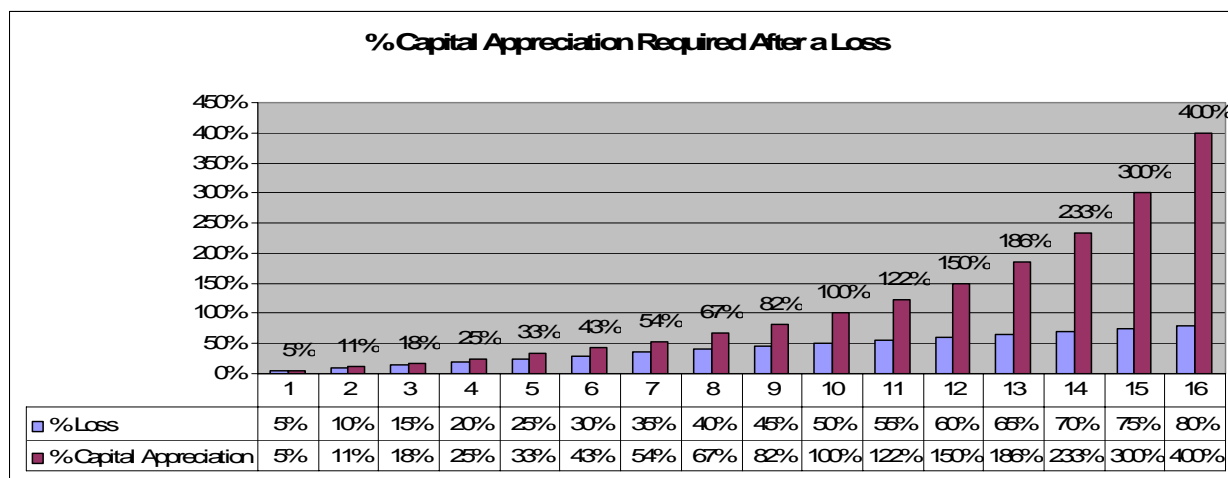




## What are the implications of portfolio losses?

Risk is inextricably linked to the pursuit of stock market returns. Recognizing the impact of this uncertainty, every investment legend adopts a wide margin of safety in selecting his/her holdings. Warren Buffet, in his folksy but concise manner, was quoted as saying, “We are certainly willing to trade off a big payoff for a certain payoff.” Why would top notch investors require such extreme levels of confidence in their investments before committing capital?

The table below highlights the capital appreciation that is required after a loss, just to get back to par. With a single digit loss, the gain required is about the same as the loss. However once the loss enters double digit territory, this monotonic progression changes very quickly. At a 20% loss, a 25% gain is needed to get back to par; at a 50% loss, a 100% gain is needed; and at an 80% loss, a 400% gain is needed.



Some readers might find the mathematics of gains and losses to be self evident. However, many investors disregard this important point in their capital allocation decisions. For instance, beyond a certain capital loss, the likelihood of a bounce back diminishes exponentially. But hope springs eternal. Most investors stubbornly chase big payoffs from their losers, rather than pursuing more certain payoffs from newer, healthier holdings.

Another capital allocation mistake is chasing after high flyers; that is, investments with very high return potential. These investments seldom provide a wide margin of safety. A good rule of thumb to follow is that the higher the return potential, the lower the margin of safety. Alternative investment funds are the most recent example of this phenomenon. During the last decade, institutional and private investors at all levels acquired alternatives with juiced up double digit returns. As the investment landscape got crowded, the managers of these funds resorted to higher and higher levels of leverage, ignoring the variability and reduced margins of safety that accompany increased leverage. Predictably, once the economic recession hit, those portfolios were decimated.

In summary, uncertainty abounds in the investment business. This is compounded by the fact that losses have an adverse and disproportionate effect on wealth. Therefore, investments must be evaluated and capital allocation decisions must be based on safety, and not on the hope of achieving future returns. Greed and wishful thinking have no place in the investment decision-making process.