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WEALTH SOLUTIONS

How to Think About Risk

Risk is perhaps the most important and least understood aspect of investing. On the one hand, with risk comes reward. It is essential in obtaining returns that help you grow your portfolio over time and meet your goals. But it is a double-edged sword. Taking too much or not enough risk, and not managing those risks correctly, can make it much harder for the investors to meet their goals.

Howard Marks has thought and written about risk for decades as he built a successful asset management business grounded in a unifying philosophy that emphasizes the primacy of risk control. What follows are his answers to 10 key questions about risk as a guide to how he thinks about it.

HOWARD MARKS
CO-CHAIRMAN & CO-FOUNDER
OAKTREE

1. What is risk?

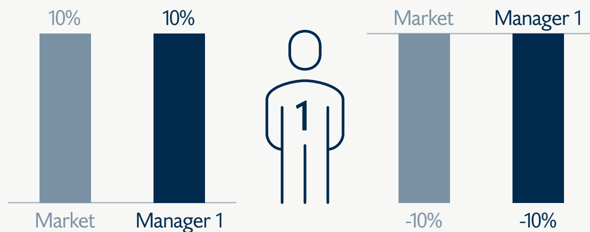
Risk is the ultimate test of a manager's skill. Asset class returns alone don't reveal how good a job the manager of those assets did. The key question is: how much risk did the manager bear to get that return? If the manager can achieve upside gains in line with the market but with downside protection that offers resilience against losses, that shows the manager managed risk effectively.

Manager's Risk vs. Return Analysis

Imagine scenarios where the market is up 10% or down 10%. What can we discern about a manager's skill from hypothetical performances?

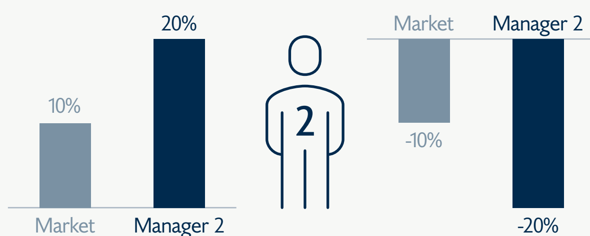
Manager 1: Up 10% and down 10%

No skill, no value added. Similar to investing in an index fund that emulates the performance of the market.



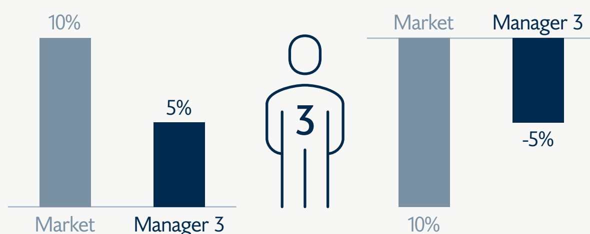
Manager 2: Up 20% and down 20%

No skill, no value added, just a lot of aggressiveness.



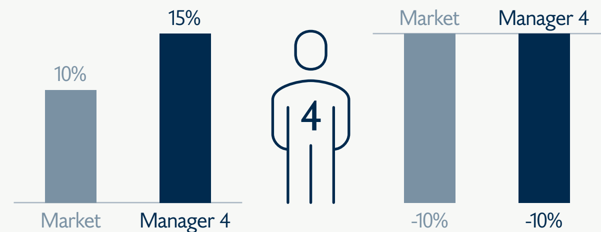
Manager 3: Up 5% and down 5%

No selection ability, no discernment, no value added, just defensiveness.



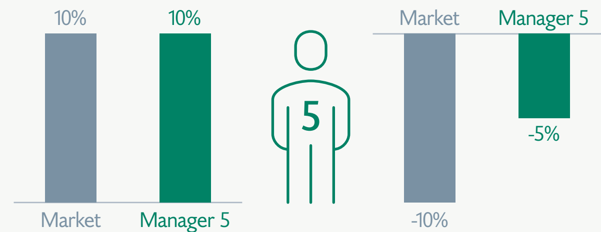
Manager 4: Up 15% and down 10%

Does better in the good times than in the bad times.



Manager 5: Up 10% and down 5%

Gains in line with the market in the good times but less decline when the market has its down spells. This shows manager skill at managing risk in down markets. This scenario effectively characterizes Oaktree, as it's not necessary to consistently beat the market but rather to navigate it successfully.



2. Is risk quantifiable?

For decades, the classic measure of risk has been volatility, which has the advantage of being readily quantifiable. However, while volatility can be an indicator of the presence of risk, it's not risk itself. For most investors, risk is the possibility of loss. After all, it is what people demand compensation for. Moreover, it is impossible to quantify risk in advance — or even in hindsight. Even a profitable investment may or may not have been risky. Was it a safe investment that was sure to do well or was it a risky investment where you got lucky or were appropriately compensated for the risk? It is impossible to know for sure.

"My belief is that risk is unquantifiable even after the fact."

— **HOWARD MARKS**

3. What are other forms of risk?

There are lots of forms of risk: Some serious, some facetious, some important, some less important and obscure. But the risk of missing opportunities is an important one; in other words, the risk of not taking enough risk.

Selling out at the low and missing out on the recovery.

2023 S&P 500 Index

For illustrative purposes only. S&P 500 Index. An investor cannot invest in an index. Source: Bloomberg.

4. Where does risk come from?

Risk ultimately stems from our ignorance about what the future holds. Of course, that ignorance comes in various degrees, but essentially, risk occurs because we don't know what's going to happen.

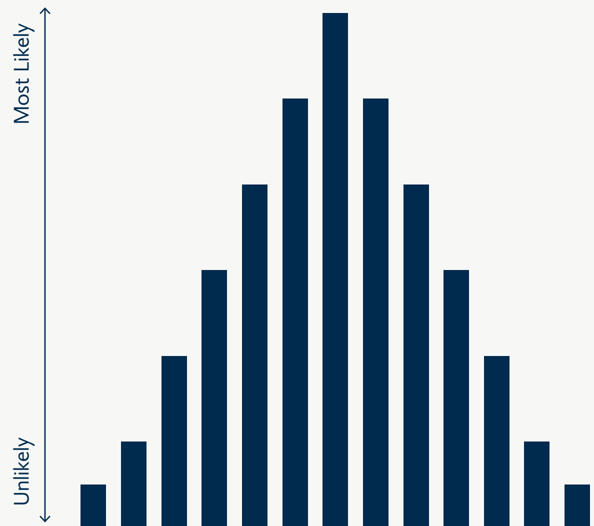
"We know what's likely to happen. We know the other things that probably could happen. Instead, we have little appreciation for the things that are highly unlikely to happen but could. And these are what we call, in modern-day terms, the tail events."

— **HOWARD MARKS**

5. How should you think about risk?

For most events that lie in the future, there are a number of things that could occur. Since we are never sure which one it will be, the future should be viewed not as a fixed outcome, but as a range of possibilities – from most likely to less likely to unlikely, but not impossible. But it is still important to accept that even when gauging those probabilities, that doesn't mean you know what's going to happen.

A range of possibilities – from most likely to less likely to unlikely, but not impossible.



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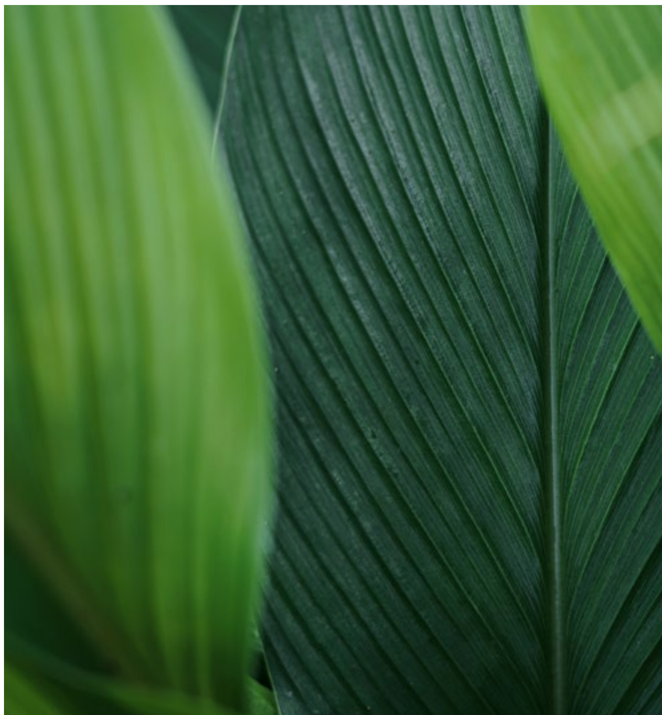
6. What is the character of risk?

Risk is counterintuitive. The degree of risk present in an investment doesn't come just from the investment, but how people participate in that investment. If they conclude that the market has become safer, they may then do riskier things. If an asset declines in price, people may assume it is risky since it is falling. But with the lower price, it actually becomes less risky. As the asset rebounds, most people marvel at how well it's doing, but the rising price makes it riskier. Risk is also deceptive. It's only in times of turmoil that investors and their strategies can be examined for the risk they really held.

"You don't find out who's been swimming naked until the tide goes out."

— WARREN BUFFETT



7. What is the relationship between risk and asset quality?

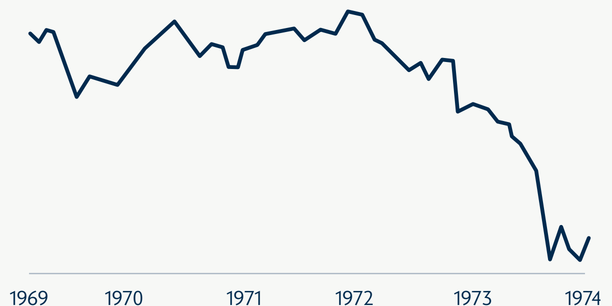
One of the most important things for every investor to learn is that risk is not a function of asset quality. This too sounds counterintuitive. There's a belief that high-quality assets are safe and low-quality assets are risky. But a high-quality asset can be priced so high that it is risky, while a low-quality asset can be cheap enough to be worth the risk.

Juxtaposition of two events.

1969

'Nifty 50' Investing

Returns of what were considered the 50 best and fastest-growing companies in America.



If you purchased the Nifty 50 stocks in September 1969 and held them for the next five years, you would have lost more than 90% of your money. The prices were too high and unsustainable. Their quality alone, or their perceived quality, did not impart to them the safety that people thought it would.

1978

Investing in the performing bonds of the lowest-quality public companies in America and making money steadily and safely.

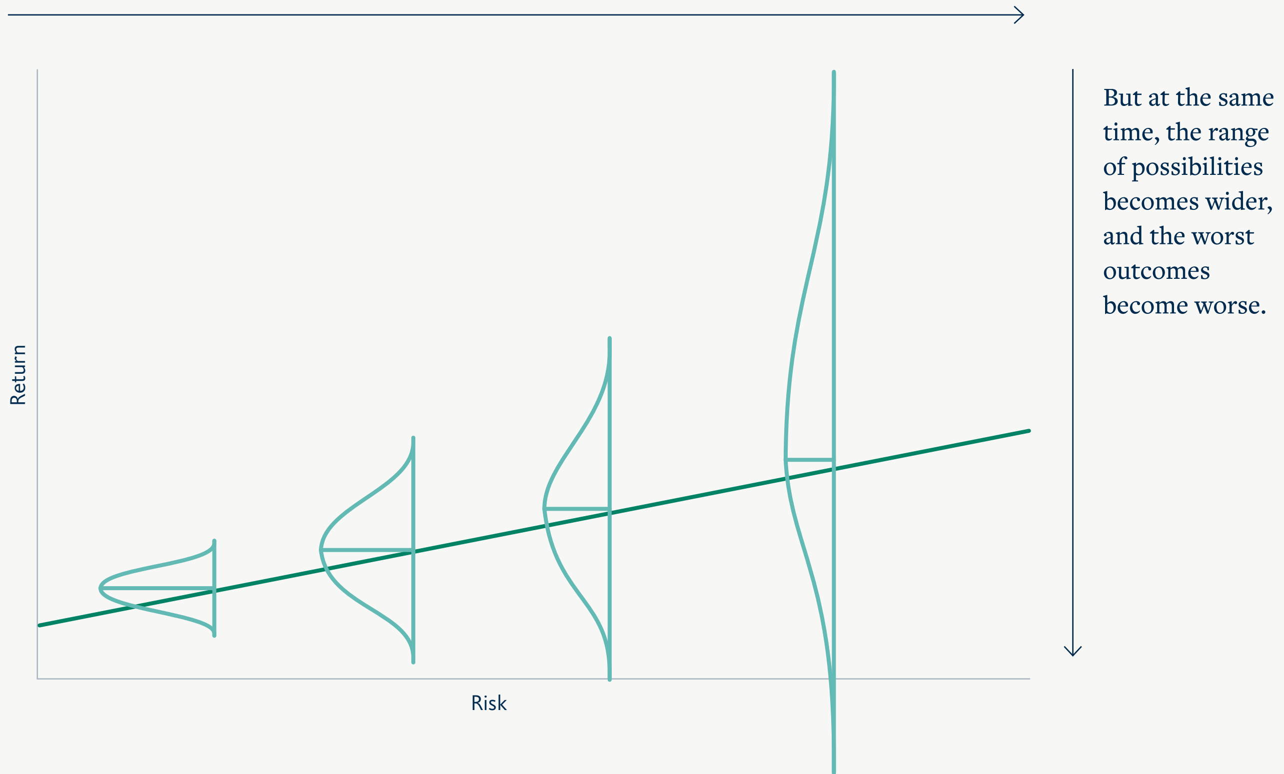
For illustrative purposes only. Source: Bloomberg.

Conclusion: It's not what you buy, it's what you pay. And investment success doesn't come from buying good things, but from buying things well.

8. What is the relationship between risk and return?

Traditionally, investors have been told that riskier assets have higher returns, and if you want to make more money, the way to do it is to take more risk. But if it is guaranteed that riskier assets produce higher returns, then they wouldn't be riskier. Instead, investors should understand that as risk increases, the expected return also increases but so does the range of outcomes – good and bad – and the potential for losses increases.

The way to think about the risk/return relationship.



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9. How should risk be managed?

At Oaktree, we manage risk continuously, not sporadically, taking risks that we're aware of, and that we can diversify. We strive to assemble portfolios that produce good returns when things go as expected and resist declines if they don't. We believe this asymmetry is the cornerstone of managing risk and providing superior investing.

In short, risk is something to be managed and controlled — but not avoided.

10. What's the bottom line?

You shouldn't expect to make money without bearing risk. But you shouldn't expect to make money just for bearing risk. Outstanding investors are outstanding for the simple reason that they have a superior sense for the probabilities of future events, and for whether the potential return compensates for those risks. This is what enables them to participate in the gains when there are gains, while avoiding losses when there are losses.

*"If we **avoid** the **losers**, the winners will take care of themselves."*

— **HOWARD MARKS**

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