HUTCHINSON
CAPITAL
MANAGEMENT

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INVESTMENT PERSPECTIVES

Risk Management

Throughout history human beings have made decisions based on how much risk is associated with achieving a specific outcome. Generally, in non-investment situations, most of us follow rules that tend to minimize risk to some degree. For example, one law that most of us follow is to not drive through a red light; the risk for most of us is too great for the rewards that we may receive. The risk is that we may either get into an accident or get a traffic ticket; the reward is that we may get to our destination somewhat faster, although not usually by very much.

Investment Risk

Investment risk is inherently related to probabilities about uncertain future events. Too frequently investors do not view the future as having a wide range of possible outcomes but instead assess what is most likely to occur (often based upon the prevailing consensus view or "conventional wisdom") and implicitly assume and explicitly act as if this scenario will occur with 100% certainty. There are numerous examples − junk bonds in the 1980s, tech and telecommunication stocks in the 1990s, and sub-prime mortgage securities and real estate in general more recently − which indicate that a general complacent attitude toward risk can lead to potentially severe consequences for investors.

Risk management may be defined as follows:

> Risk management is the identification, assessment, and prioritization of risks followed by coordinated use of resources to minimize and control the probability of unfortunate events or to maximize opportunities. Risks can come from uncertainty in financial markets, project failures, legal liabilities, credit risk, accidents, natural causes and disasters as well as deliberate attacks from an adversary.

Financial Risk

One of the key elements in the recent recession and bear market was the sense that risk had somehow been (almost) eliminated. There was a widespread perception that making investment decisions was easy and that the investments that were made were virtually risk free. People could buy houses with inadequate financial resources, mortgages could be bundled up into fancy investment packages, insurance could be sold on these packages, and whatever risk remained would be spread so that no specific individual or institution would be hurt. As it turned out, these assumptions proved to be wrong.

Howard Marks, a well respected investment counselor, talks about risk in the following way.

> "Belief that risk had been banished was a key element in allowing people to engage in practices they would otherwise view as risky, and in permitting assets to be bid up to prices that would clearly be too high in a world perceived to involve risk. Worry and its relatives – distrust, skepticism, and risk aversion – are essential ingredients in a safe financial system. Worry keeps risky loans from being made, companies from taking on more debt than they can service, portfolios from becoming overly concentrated, and unproven schemes from turning into popular manias. When worry and risk aversion are present as they should be, investors will question, investigate and act prudently. Risky investments either won't be undertaken or will be required to provide adequate compensation."

Risky Investments

Many investors believe that when an asset class has appreciated dramatically in value that it must be a great investment and they need to buy now. Unfortunately, in our opinion, this is exactly the wrong time to buy! Investing in very popular asset categories for a sustained period of time is a common risky investment strategy that has often produced extremely poor long term returns. As we mentioned above, three recent examples are investments in the technology area in the late 1990s, in single family houses in the mid to late 2000s, and in financial stocks in the last several years. Currently, we believe that the enormous popularity of Emerging Market securities is another great example of an asset bubble. We believe that investors are once again becoming too complacent about the risks that exist in these less developed markets and are willing to pay ever-higher prices for these securities.

Conversely, most investors believe that as an asset class falls in value, it is riskier and not a good time to invest. They are concerned that the asset will continue falling and they will lose significant amounts of money. In reality, we believe that as stocks are falling, the risk of buying high quality investments diminishes and it can be a great time to invest. One example is retail stocks: during the depths of a recession prices of these companies and investor expectations are usually low as investors are concerned about near-term events related to the stock rather than three-to-five year results after the recession ends.

Risk of Over Diversification

Contrary to popular belief, it is our opinion that diversification is not an answer to mitigating risk. For example, owning 100 or 200 stocks in mediocre companies is not better than owning 15 to 20 stocks of great companies. Risk exists when the investments you own are not well understood. Quite simply, if you don't know <u>why</u> you bought the stock you won't know <u>when</u> to sell it. When a stock appreciates or depreciates significantly, it is critical that you understand the root cause for the event in order to make the correct investment decision.

Warren Buffet and his partner, Charles Munger continuously are advocating that the whole secret of investing is to find places where it's safe and wise to invest in a small number of high-quality stocks. If you truly know what you have invested in, your performance results will usually be much better over time.

Our Role in Managing Risk

The concept of risk management has become increasingly important to investors in light of the financial market and economic turbulence over the past two years. As fiduciaries, we view our role to be stewards of our clients' hard-earned assets and therefore place a heavy emphasis on risk management in our investment decision making process, regardless of current market conditions at any time. There seems to be a common misconception that investing in general − whether in art, precious metals, real estate, commodities or stocks and bonds − requires taking high levels of risk in order to generate high returns. However, as value investors we disagree with this assertion. In our view, avoiding significant loss is the main requirement for sustaining attractive rates of return. Accordingly, we view one of our important roles to be that of "paid skeptic" by assessing potential downside risks and determining the possible scenarios should the often rosy picture painted by Wall Street analysts or company management turn out to be wrong.

Our approach toward mitigating risk is to, as completely as possible, understand each of the investments we have made for our clients. We spend time valuing businesses and, in our opinion, paying less than their intrinsic value. If we do our job properly we reduce the risk of buying a company at a high price. Additionally, we spend significant time reviewing the downside possibilities; if we are comfortable with the value of the business in a worst case scenario, then we feel that we have minimized risk.

Typically, each of our clients owns approximately 20 stocks in 15 to 20 different industries. When either a very favorable or unfavorable event occurs regarding one of the stocks that you own, we believe that our in-depth understanding of the situation helps us to make the correct buy/sell decision. Another way that we have attempted to dampen risk is to use a ladder of high quality bonds. Typically each of our clients owns eight to ten bonds laddered one year apart. In the recent financial crisis one of the few investments that rose in value while the stock market was falling was high quality bonds. We call bonds the "shock absorbers" of the portfolio. Leading up to the recession and market downturn starting about two years ago, Wall Street talked about how owning multiple asset classes of stocks would minimize risk, but nothing could be further from the truth. Almost all of the asset classes fell in unison − the only investments that did not were high quality bonds and cash.

Conclusion

In summary, our strategy has been (and will continue to be) to take only those risks that we consider to be prudent. Our overall philosophy is to invest in those stocks that will produce a competitive return and to own high quality bonds. We will invest in those companies that we believe are selling for low valuations, are well-run, have strong financials, have an excellent management team, and have good prospects for future success. By following this philosophy, we believe that we will protect our clients' assets while producing competitive returns over market cycles.

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

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