LIONRIDGE
QUARTERLY REPORT

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Commentary

The Lionridge Approach to Risk

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Equity markets rose modestly in the third quarter of this year. Our benchmark* was up 2.1%, with our Total Equity Portfolio return lagging slightly at 1.8%. The difference was largely influenced by our cash position which stands at around one third of the portfolio. There are a lot of great companies out there that I'd love to buy for you, but only if the price is right. If you pay too much for a great company, it's still a lousy investment.

My approach to building wealth by investing in stocks is focused on the power of compounding over the long term, as opposed to trying to focus on short term gains. Inherent in this is favouring companies that are wealth creators, and at the same time trying to mitigate the risk of permanent loss of capital. I take a view of risk that is somewhat antithetical to the popular conception that one must take on more risk to achieve higher returns.

It is certainly true that a portfolio of stocks will be riskier than short term government bonds, but within the sphere of stock investing itself there exists a risk/reward paradox in the sense that one can strive for outstanding returns while being exposed to less risk than that of the stock market as a whole. This is a concept I came across many years ago, it was my "light bulb" moment while I was exploring the philosophy of value investing.

Risk is usually defined by the investment industry as volatility, but there are a couple of problems with this. Firstly, measures of volatility typically include upwards movements as well as downwards, but where is the harm in one's investments increasing in value? Secondly, and more egregiously, the industry tends to focus on short term volatility. But stocks are ownership shares of companies, and short term price swings often have nothing to do with the long term prospects of a company.

If anything, volatility is welcomed by true value investors, as it can provide great opportunities to buy great companies at bargain prices. But to take advantage of such opportunities, one must have the mindset and temperament to distinguish between short term volatility and the risk of permanent loss of capital.

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This brings me to another perpetual issue in the investment industry - the focus on the short term versus the long term. Stocks are long term assets, and should only comprise that part of peoples' assets that they don't need to draw from for a long period of time (at least seven years in my opinion). If one is not compelled to sell their holdings in the short term, then short term declines in price do not result in an actual loss of capital if those companies are expected to be around for the long term. I view permanent loss of capital as the meaningful definition of risk, and this risk is effectively mitigated by buying sound companies only at advantageous prices.

This approach can only be effective if one has the luxury of patience - i.e. not being subject to short term pressures. It is short term thinking that causes many professional investors to hide behind the smokescreen of portfolio over-diversification as a supposed risk-reduction tool. Often, these investors are more focused on their own career risk than they are on clients' risk and are accordingly afraid to deviate too much from the markets over short term periods. Taken to an extreme, the pressure to over-diversify has led to the popularity of "low cost" index funds. The fees may be lower, but as index funds make no effort to screen out inherently risky stocks and the resulting potential of permanent losses, are they truly lower cost in the long run?

The magic of compounding is not interrupted by short term volatility. If one responds properly, volatility can be used to enhance the compounding of wealth, and if one responds poorly, compounding of wealth can be inhibited. I'm highly focused on risk management, very choosy about the type of companies I deploy your capital in, very sticky on the price I'm willing to pay for them, patient with the companies we own, and patient in deploying your capital. This is how I've managed to achieve results while exposing you to lower downside volatility than the equity markets.

At Your Service,

Hardev Bains, LLB, MBA, CFA
President and Portfolio Manager

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* Benchmark from November 30, 2017: 40% S&P/TSX Total Return; 60% MSCI World (Gross in CAD$). Benchmark from inception to November 30, 2017: 45% S&P/TSX Total Return; 35% S&P 500 Total Return (CAD$); 20% MSCI EAFE (CAD$).
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