Zachary Scott

INVESTMENT BANKERS

INSIGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
FALL 2014

# Investment Risk and the Ebb and Flow of Markets

## Avoiding permanent loss of value in a down market cycle.

*by Mark Working*

There are many categories of investment risk, but the potential for permanent loss of value ranks highest in importance for private business owners and investors. Permanent loss can come from poor execution, market disruption (see nearby article, Mitigating Disruption Risk), and monetization in a down market cycle. Our focus in this article is the last point, which is the impact to business owners when the intersection of their personal investment horizon coincides with market cycles. Far from suggesting that we are proponents of market timing as an investment philosophy, it is still prudent for an owner of a single asset, such as a privately held business, to take into account the ebb and flow of markets and how timing might impact individual and family wealth.

There are times when the cost of taking risk, relative to the potential return to be earned, falls outside an individual business owner's tolerances. Although not necessarily intuitive, risk is low when everyone sees a bogeyman behind each corner, and high when those same people act like nothing can go wrong. Whether measured by the price of credit, valuation multiples of companies, or the historical trough in interest rates, today's risk pendulum appears to have swung into the "high" risk range.
Put a different way,

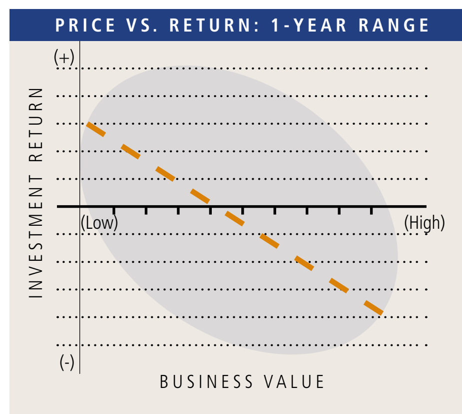
*"the less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs."*
–*Warren Buffett*

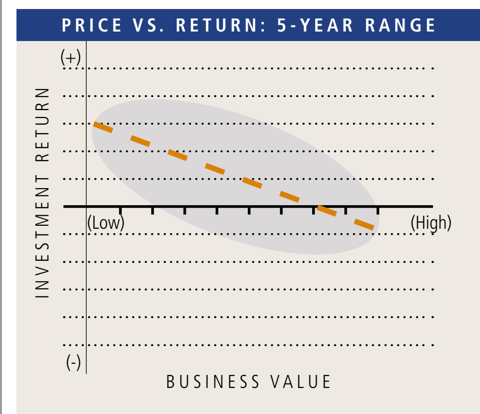
### WHAT IS INVESTMENT RISK?

Many internal and external events and forces influence the fortunes of businesses; therefore, their values ebb and flow. Academics call this ebb and flow of value volatility: the greater the variation of business results, the higher the volatility, and the greater the risk. Variation is measured historically and assumed to be prospective. Since different businesses may have different measured levels of historical volatility, they are considered to be more or less risky.

To illustrate the difference in volatility of investment returns over different investment horizons, the nearby graphs show the range of variation in returns realized in one year versus five years. Note that variability moderates over a longer time frame and the expected return is lower when the price paid is high (regardless of time frame), and vice versa.

In addition to the unpredictability of short-term returns, markets ebb and flow. The chart at the bottom of the page shows the movement of the S&P 500 since 1996, showing the gains and losses during the intervening periods.

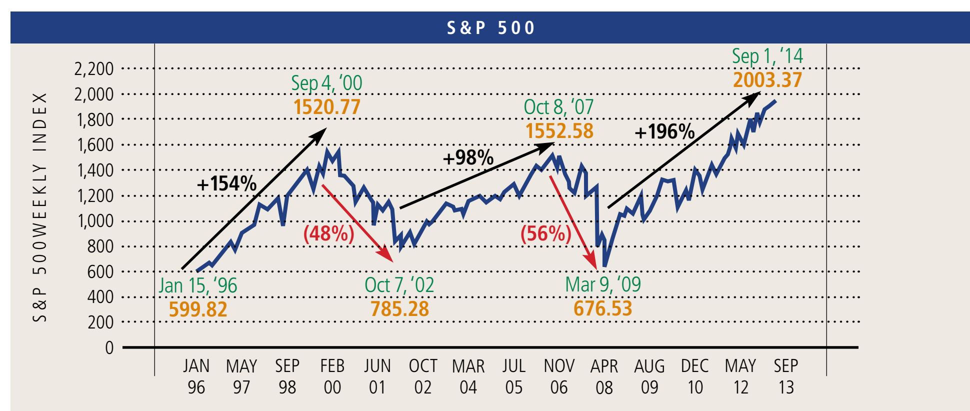



In October 2007, if an investor knew liquidity would be required 18 months hence, they would have been disappointed to find that they had lost half of their value by waiting to sell their investments until the liquidity was needed. Since investment markets have cycles, having to sell at a particular time—when market conditions are disadvantageous—will lead to permanent loss. When an owner's investment horizon is short, he is subject to the risk of changes in overall market conditions, market position, and performance of the business itself, any of which can contribute to a loss of value at a specific point in time.

### CONSIDERATIONS FOR PRIVATE BUSINESS OWNERS/INVESTORS

Private business owners are not reminded of the daily changes in investor sentiment and, therefore, are somewhat insulated from volatility caused by investor market cycles. Because private business owner investment horizons tend to be long, daily, monthly, or quarterly value measurements are rarely a consideration. Increasing value comes from making decisions today to put the business in a position to suc-



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ceed years down the road, not to hit guidance on this quarter's earnings.

Risk is different for an owner than for the professional investor or wealth manager. The business owners' primary wealth is often locked in a single illiquid asset – the private business. The owner makes a "buy" decision each day on the equity of the business, and makes a "sell" decision once in a career. Making that timing decision can make a significant impact on family wealth. The choice is not easy or simple.

The value of a business is a function of the relationship between cash flows (each period and at time of sale) the business will produce in the future, and a hurdle return appropriate for the risk of the business. Investor sentiment and recent experiences bear heavily on expectations for achieving future performance. The psychology of how investors view the future can change quickly, often having nothing to do with the specific business and its performance, thereby affecting perceptions of value. The danger of value loss comes from ignoring the fact that private business values are susceptible to market cycles and believing that multiples can be independent of conditions within the control of the business owner. Today's multiple will not hold constant to be applied to next year's increased performance.

There are periods of growth for specific businesses that are so significant that they can overwhelm consideration of market value cycles. But, it pays to do the analysis to understand the tradeoff. We are firm believers in modeling different future scenarios for businesses in which different factors are weighed and probabilities assigned. The purpose of the analysis is to assess the range of future outcomes and assign probabilities to each to gain a perspective on the expected outcome and the range around that expectation.What models cannot do is predict the future or determine if the risk is appropriate for the individual situation; they merely provide a framework for the business owner to fairly evaluate the risks and potential outcomes.

## WHEN IS THE RIGHT TIME?

As a famous economist once quipped,

> *"There are two classes of forecasters: those who don't know, and those who don't know they don't know."*
>
> *– John Kenneth Galbraith*

Just because one can't precisely predict the future doesn't mean that efforts to evaluate it are not worthwhile. It is the indeterminate nature of future events that creates investment risk. Without it, there would be no ability to profit. But, there are periods in business cycles where investors are paid less or more for bearing risk. Despite the phrase, "investors get paid for taking risk", it is not a corollary that by taking risk, one will earn more. When investors do and pay for things they don't understand, simply because others are doing them, the price of risk decouples from the expected value return represented by accepting that risk. This is an indicator that risk of permanent loss is highest. As risk tolerance becomes widespread, the scene is set for future losses.

Owners who have a relatively short investment horizon should consider the negative effect on their wealth if valuation market conditions move from the lofty levels currently being experienced towards historical averages. These owners bear a disproportionate level of risk of permanent loss. When, and by how much, can't be known. The words of Carver Read, British philosopher, seem appropriate -

> *"It is better to be vaguely right than exactly wrong."* **ZS**

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## ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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