The Journal of Portfolio Management

In Search of the Meaning of Risk

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Convention and mathematics define risk for investors as volatility, but the flaws in this definition are an open secret. How can we reveal the true nature of risk? An admittedly stylized discussion attempts to answer this question.

Consider a ranking of assets in terms of riskiness that most of us would accept: dollar bills, Treasury bills, long bonds, General Electric, a small stock on the Malaysian stock exchange, a machine to make contact lenses, an entire steel plant. Although the assets range from low to high in terms of the volatility in their values, the list suggests two more attributes: The assets range from high to low in terms of liquidity, and from low to high in specific risk.

The assets also range roughly as to term or lifetime. The steel plant and the contact lens machine may have shorter lives than a thirty-year bond in terms of cash flows, but holders of thirty-year bonds can shorten the period of their ownership by selling the bond in the marketplace. That alternative is not available to the owner of the machine or the factory.

But why do volatility, liquidity, specific risk, and life of investment matter? They matter because the cost and the difficulty of changing our minds increases as we go from the instant liquidity of dollar bills to the inescapable buy-and-hold caused by the specific risks of the machine and the factory. Required returns are likely to vary accordingly.

That is by no means the whole story. Although volatility, liquidity, specific risk, and lifetime appear to cover the primary elements of risk, the picture is still incomplete. By different measures, the magnitude of the risks may run in the opposite direction of the traditional one, with money, bonds, and stocks the most risky, and machines and factories the least risky.

The owners of money and the marketable securities are passive. All they own is paper. They have no control over the risks they face in owning such paper; inflation is a risk for the money and the government bonds, while deteriorating buying power is a risk for the stocks and the corporate bonds. Even worse, these investors have no exit strategy beyond themselves. They cannot bail out of these assets without the cooperation of others willing to buy or to accept in exchange what they wish to sell. Thus, these assets are riskier than they appear.

The owners of the machine and the factory are active. These owners may not be able to reverse their decisions by selling out to others, but they can often change the conditions under which the asset in question is operating. If fixed assets were only buy-and-hold with no control over outcomes, no one except a fool would own such assets. The owners of the machine or the factory can, among other things, vary the price at which they sell their product, rearrange their production arrangements to cut costs, or seek

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new markets. Control of outcomes is a precious method of risk management that goes along with assets that are something different from paper. Furthermore, the cash flows from fixed business assets are in most instances greater than the cash flows received from paper assets, which means that realization of their value comes sooner. Even better, these cash flows are directly under the control of the owners. Thus, fixed assets are less risky than they appear.

Seen in this light, the trendy accumulation of so-called alternative assets such as private equity, venture capital, and real estate by pension and endowment funds makes good sense. Nevertheless, I suspect that the wrong reasons are motivating the move. The lure appears to be in the sugarplums of goodies in the IPO exit strategies, or the expectation that fixed assets are always convertible into paper assets. That reward is an uncertain one. The real attraction of fixed assets, which receives almost no attention, is the impact of these shifts on the riskiness of the total portfolio.