Note on the Concept of "Risk"

An extract from Benjamin Graham's classic bestseller on value investing "The Intelligent Investor" 1973 by Harper and Row Publishers Inc.

It is conventional to speak of good bonds as less risky than good preferred stocks (preference shares) and of the latter as less risky than good common stocks (shares). From this was derived the popular prejudice against common stocks because they are not "safe", which was demonstrated in the Federal Reserve Board's Survey of 1948. We should like to point out that the words "risk" and "safety" are applied to securities in two different senses, with a resultant confusion in thought.

A bond is clearly proved unsafe when it defaults its interest or principal payments. Similarly, if a preferred stock or even a common stock is bought with the expectation that a given rate of dividend will be continued, than a reduction or passing of the dividend means that it has proved unsafe. It is also true that an investment contains a risk if there is a fair possibility that the holder may have to sell at a time when the price is well below cost.

Nevertheless, the idea of risk is often extended to apply to a possible decline in the price of a security, even though the decline may be of a cyclical and temporary nature and even though the holder is unlikely to be forced to sell at such times. These chances are present in all securities, other than United States savings bonds, and to a greater extent in the general run of common stocks than in senior issues as a class. **But we believe that what is here involved is not a true risk in the useful sense of the term.** The man who holds a mortgage on a building might have to take a substantial loss if he were forced to sell it at an unfavorable time. That element is not taken into account in judging the safety or risk of ordinary real – estate mortgages, the only criterion being the certainty of punctual payments. In the same way the risk attached to an ordinary commercial business is measured by the chance of its losing money, not by what would happen if the owner were forced to sell.

In chapter 8 we shall set forth our conviction that the bona fide investor does not lose money merely because the market price of these holdings declines; hence the fact that a decline may occur does not mean that he is running a true risk of loss. If a group of well-selected common-stock investments shows a satisfactory over all return, as measured through a fair number of years, then this group investment has proved to be "safe". During that period its market value is bound to fluctuate, and as likely as not it will sell for a while under the buyer's cost. If that fact makes the investment "risky", it would then have to be called both risky and safe at the same time. This confusion may be avoided if we apply the concept of risk solely to a loss of value which either is realized through actual sale, or is caused by a significant deterioration in the company's position – or, more frequently perhaps, is the result of the payment of an excessive price in relation to the intrinsic worth of the security. 1

Many common stocks do involve risks of such deterioration. **But it is our thesis that a properly executed group investment in common stocks does not carry any substantial risk of this sort and that therefore it should not be termed "risky" merely because of the element of price fluctuation. But such risk is present if there is danger that the price may prove to have been clearly too high by intrinsic-value standards – even if any subsequent severe market decline may be recouped many years later.**

1. ***In current mathematical approaches to investment decisions, it has become standard practice to define "risk" in terms of average price variations or "volatility". See, for example, An Introduction to Risk and Return, by Richard A Brearley, the M.I.T. Press, 1969. We find this use of the word "risk" more harmful than useful for sound investment decisions – because it places too much emphasis on market fluctuations.***

About the Author

Benjamin Graham was Warren Buffett's (the world's most successful investor) mentor at Columbia University and employer for a number of years. Buffett accredits much of his own success to Graham's value investing techniques which remain highly applicable in today's and tomorrow's investment world.