

Westcourt Solutions



The Many Faces of Investment Risk

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Among the many notable missives delivered by the “father of modern investing”, Benjamin Graham is this gem: “The essence of investment management is the management of risks, not the management of returns.” The basic meaning behind this is that an investor’s primary function in making investment decisions is to evaluate investments’ risks rather than to simply chase their potential returns.

It's hard to think that any serious investor would take issue with the basic maxim of “risks first, returns second”. The challenge, however, is to determine what exactly “risk” means. Turns out that, like so many of life’s vagaries, risk is very much in the eye of the beholder.

What is risk when it comes to investing? While there may be as many definitions as there are investors, investment risks generally fall into four basic categories: the risk of volatility, the risk of permanent loss of capital, illiquidity risk, and familiarity risk.

Volatility: The Conventional View

Volatility measures the degree to which an investment’s price fluctuates over time, typically expressed as standard deviation. In modern portfolio theory, a highly volatile investment is viewed as riskier because its short-term returns deviate more widely from the mean. This metric is useful for comparing (primarily publicly traded) securities or building diversified portfolios.

However, volatility only captures market sentiment, not whether intrinsic value is actually at risk. Some of the best long-term investments—such as purchasing equities during market dislocations—are volatile precisely when they offer the greatest opportunity. This notion is encapsulated in the famous Warren Buffet quote “Be fearful when others are greedy and greedy when others are fearful”, suggesting that perceived risk can actually provide great investment opportunities for savvy investors.

Permanent Loss of Capital: The Investor’s Core Concern

Many seasoned investors, including Warren Buffett

and Howard Marks, define risk as the possibility of permanent loss of capital rather than temporary fluctuation in prices. A stock that falls by 50% and never recovers is far riskier than one that drops sharply and rebounds. Measuring this type of risk involves assessing balance sheet strength, cash flow durability, competitive positioning, and management discipline. Stress testing scenarios—such as recession exposure or regulatory change—helps investors evaluate how resilient an asset’s value truly is.

The problem, of course, in using the risk of permanent loss of capital as a guide to making sound investment decisions is that it is often very hard to distinguish between investments falling in value precipitously as evidence simply of volatility or of a more pernicious cause.

Illiquidity: The Cost of Inflexibility

Illiquidity risk arises when assets cannot be sold quickly without a significant price concession. As the private markets have grown exponentially in recent years (led by asset classes including private equity, real estate, private credit and venture capital), investors have learned (often the hard way) that, even when packaged in funds that purport to provide liquidity virtually on demand, private assets should not be part of investors’ portfolios that might be required in liquid form in the short term. While the emergence of secondary markets in private assets has provided some relief to investors seeking liquidity at the “wrong time”, the law of supply and demand results in sellers often selling even strong assets at significant discounts to their true value in order to achieve liquidity when desired.

As a result, Investors in less liquid assets demand higher potential returns, or “liquidity premiums,” to compensate for this risk. Measuring illiquidity involves understanding both the expected holding period and how quickly an asset’s market clears under stress. For those with long investment horizons, this risk can be acceptable or even desirable, as it can provide outsized long-term returns and can discourage emotional selling.

Familiarity and Behavioral Risk

Finally, familiarity plays a hidden role in how investors perceive risk. People tend to prefer investments they understand—often domestic markets or industries they know well. While this familiarity can reduce perceived risk, it also creates both concentration risk and opportunity costs by limiting diversification. Objective measurement requires looking beyond comfort zones and quantifying exposures across asset classes, geographies, and sectors.

While many of the world's most famous investors subscribe to the "I only invest in things I understand" principle, this concept must be qualified to add "And I will never stop in my quest to become informed about assets classes and strategies about which I am currently ignorant but might profit from over time."

A good example of this is Warren Buffet's long-term refusal to invest in emerging technologies. A strict adherent to the "invest only in what you understand" ethos, Buffett has expressed regret about his reluctance to engage with top technology leaders like Amazon, Google, and Microsoft, which saw dramatic growth and have transformed the global economy over the last 30 years. He admitted, in multiple interviews, that he underestimated these businesses and did not foresee how dominant they would become. Notably, he once remarked that watching what Jeff Bezos achieved at Amazon was "extraordinary", and acknowledged he was simply "too dumb to realize" the company's true potential.

Ultimately, risk is multidimensional. Managing it effectively means balancing quantitative measures like volatility with qualitative factors such as durability, liquidity, and psychology. Investors must be able to sleep at night notwithstanding the "risks" that they have taken in their investments. To do so requires that they understand both the nature and the magnitude of the risks they have taken, and to manage those risks to align with their ability to withstand those risks over time.

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