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Risk, Its Management and Disclosure

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A popular fallacy considers entrepreneurial profit a reward for risk-taking. It looks upon the entrepreneur as a gambler who invests in a lottery after having weighed the favourable chances of winning a prize against the unfavourable chances of losing his stake. This opinion manifests itself most clearly in the description of stock-exchange transactions as a sort of gambling.

Every word in this reasoning is false. The owner of capital does not choose between more risky, less risky, and safe investments. He is forced, by the very operation of the market economy, to invest his funds in such a way as to supply the most urgent needs of the con-sumers to the best possible extent …

There is no such thing as a safe investment. If capitalists were to behave in the way the risk fable describes and were to strive after what they consider to be the safest investment, their conduct would render this line of investment unsafe and they would certainly lose their input. For the capitalist there is no means of evading the law of the market that makes it imperative for the investor to comply with the wishes of the consumers and to produce all that can be produced under the given state of capital supply, technological knowledge, and the valuations of the consumers. A capitalist never chooses that investment in which, according to his understanding of the future, the danger of losing his input is smallest. He chooses that investment in which he expects to make the highest possible profit.

Ludwig von Mises
Human Action (1949)

Is it more serious to convict an innocent man or to acquit a guilty one? That will depend on the consequences of the error. Is the punishment death or fine? What is the danger to the community of released prisoners? What are the current ethical views on punishment? From the point of view of mathematical theory, all that we can do is to show how the risk of the errors can be controlled …

J. Neyman and E. Pearson
Philosophical Transactions of the Royal Society (1933)

An investment is the act of exchanging money for a security which confers title to a business, debt or building. In such a transaction, the investor typically incurs inconvenience – namely, the money required to buy a capital good (such as a stock or bond or title to real estate) cannot be used to buy a consumer good or service (such as a house or motor car or overseas holiday). To invest is thereby to defer current gratification. The investor is prepared to wait because he believes that the investment will generate certain benefits over time, and that these eventual benefits will outweigh the inconvenience incurred in the meantime. One exchanges cash today for (say) a title to a commercial building because one expects that the property will generate a stream of earnings (i.e., regular payments of rent) sufficient to finance some desired level of consumption tomorrow, the day after and into the indefinite future. The investor postpones the consumption of jam today so that (he hopes) he can consume more jam (or give it to others) tomorrow. In Warren Buffett's words, "investing is laying out money now to get more money back in the future – more money in real terms, after taking inflation into account."

To invest is necessarily to make assumptions about the future. But tomorrow is always uncertain and our assumptions about it never correspond perfectly to the eventual reality. As a result, an outlay of cash today will almost certainly not generate a stream of income that corresponds precisely to one's projections. There's a significant chance that the stream will fall well short of expectations; and there's some chance that it will produce no stream at all. Hence *risk* – the chance that one's plans go awry – underlies any investment.[1]

According to the mainstream, the greater is the anticipated return from an investment the greater is its risk. A Commonwealth Government bond, for example, is conventionally regarded as "risk-free;" so too is a bank deposit.[2]

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1 Events in the future are either known (i.e., perfectly predictable), imperfectly predictable or uncertain. Imperfectly predictable events are unknown, but can be described statistically. Rothbard (*Man, Economy and State: A Treatise on Economic Principles*, 1962) has written: "Risk occurs when an event is a member of a class of a large number of homogeneous events and there is fairly certain knowledge of the frequency of occurrence of this class of events. Thus, a firm may produce bolts and know from long experience that a fixed proportion of these bolts will be defective, say one percent. It will not know whether any given bolt will be defective, but it will know the proportion of the total number [that are] defective." Finally, many events are unpredictable (i.e., characterised by uncertainty). "Uncertainty" describes our state of mind in relation to the future when trying to anticipate changes that cannot be "modelled" with probability distributions. The distinction between *risk* and *uncertainty* is central.

2 Given the government's ability to tax its hapless subjects with impunity, the likelihood that a Western government's bonds formally default is practically nil. Hence their payments of interest and repayment of principal are virtually assured and almost perfectly predictable. Of course, during the course of the investment the purchasing power of the interest and principal virtually always falls; and if the shrinkage exceeds the sum of the interest payments, then the investment incurs a loss. In this vital respect, the bonds of governments – particularly those of countries like Britain, France, Germany, Japan and above all the U.S., which are effectively insolvent – are hardly "risk free." Indeed, they can be "loss guaranteed." For details, see *The Intelligent Australian Investor* (John Wiley & Sons, 2005, pp. 65-68).

Because governments serve special interests rather than the general public, the streams of income generated per dollar invested in their bonds tend to be relatively small. Privately-owned real estate does, however, help producers to serve consumers. Yet renters may not honour their obligations; the location of a building may become less desirable over the years; taxes and costs of maintenance may unexpectedly rise; the vicissitudes of weather or climate may cause unanticipated damage, etc. Considered as a whole and applied to most real estate, these probabilities are not great. But they are not negligible. Hence rental income is more variable, less predictable and less assured over time than are interest payments from banks and governments. In order to compensate for this reality, streams of rental income per dollar invested in real estate tend to be greater than the streams of interest generated by allegedly "risk free" assets.

The returns from the ownership of businesses and corporate bonds tend to be even more variable. This is because (ignoring the extent to which the cumulative effects of the central bank's inflation constitute default by stealth) a business is far more likely to fail than the Commonwealth is to default; further (given that a business generates profits for its owners only after the claims of employees and creditors are discharged), the ability of businesses to generate earnings and make interest payments are least predictable and least assured. In order to compensate for this uncertainty, investors typically demand a relatively large stream of earnings per dollar invested in these assets.

> *Clearly, then, each class of investment – say, debt versus equity – has certain characteristics; and within each class, each individual investment has its own advantages and disadvantages. This point applies to the shares of Leithner & Co. Because it is a business which in turn is a part-owner of other businesses, it follows that the returns from the ownership of these shares should be regarded as less certain than those which derive from residential or commercial real estate, Commonwealth bonds or bank deposits.*
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> *It is therefore imperative that potential and actual shareholders of Leithner & Co. recognise several unpleasant possibilities. These include a loss of capital.*

A Definition and Four Categories of Risk

If a company's income and the value of its assets could be predicted with certainty, then the price of its stock could be computed in a relatively straightforward way. Because these numbers cannot be predicted perfectly (or perhaps at all), the prices of securities represent mere forecasts of future values. Ben Graham and Warren Buffett emphasise that the successful investor reasonably accurately ascertains the value of a business (or a bond or a building, etc.) and pays a bargain price relative to that value (see also Investment Philosophy and

Principles). Successful investing is easier to describe than to undertake. This is not only because it requires that one posit realistic assumptions about the future; one must also possess a plausibly accurate understanding of the past and present. Yet our comprehension of yesterday and today is always, to some extent, mistaken;[3] and our assumptions about tomorrow, it is important to repeat, are always to greater or lesser extents incorrect. For this reason, *risk (i.e., the likelihood that certain desired events do not occur, or that undesirable events do occur)* unavoidably accompanies any investment.

For a Graham-style value investor, four categories of risk are most noteworthy:

1. the possibility that what the investor believes to be a good ("growth") business or industry, such as banking and mining, is actually a mediocre or poor ("cyclical") one;
2. the possibility that what is presently a sound business ceases in the future to be so – that is, the investor complacently extrapolates current operations into the future;
3. the possibility that an unreasonably high price is paid for a business, debt or building – in other words, the investor's valuation is overconfident;[4]
4. the possibility that fallacies and falsehoods are accepted as truths, and economic illiteracy is lauded as wisdom.[5]

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[3] If you have time on your hands, read Ludwig von Mises, *The Causes of the Economic Crisis and Other Essays Before and After the Great Depression* (1931, repr. Ludwig von Mises Institute, 2006); Lionel Robbins, *The Great Depression* (Macmillan, 1934); Wilhelm Röpke, *Crises and Cycles* (William Hodge and Co., 1936); and Richard von Strigl, *Capital and Production* (Julius Springer, 1934). Then compare these books to Ben S. Bernanke, *Essays on the Great Depression* (Princeton University Press, 2004). Who – the Austrian School economists or Bernanke – more accurately diagnoses the cause of the Great Depression? Whose antidote is most sensible? Either the Austrians were (and remain) wrong, or Ben Bernanke is wrong; and if Ben's mistaken, then God help us all – for just as the Austrians said of John Maynard Keynes in the 1930s, the prescriptions of today's mainstream will do no good and considerable harm.

[4] Notice that categories 1-3 of the Grahamite conception of risk are diametric opposites of the mainstream conception. To Graham and his followers, the higher the risk, the *lower* is the subsequent return. One of the most frequent mistakes that investors commit – that is, one of the most pervasive risks they face – is the exchange of too much money for a given security. In time, excessive valuations tend to be corrected, leading to poor returns on such investments. The greater the overpayment, the lower is the long-term return.

[5] Mainstream economics and finance are little more than mountains of fallacies and falsehoods. Consequently, a staggering number of fallacies and falsehoods has long afflicted Australian investors. They have periodically caused huge losses; and because all but a few investors cling fanatically to them, they will continue to lead many to grief. Among the most damaging of these fallacies and falsehoods: the U.S. Government is solvent (see Avoid the Rush); consumption begets prosperity (see Why Have They All Been Fooled?); central banks can artificially depress certain rates of interest without unleashing a damaging cycle of boom and bust (see Interest Rates, Corporate Debt and the Business Cycle); government, and particularly Western democratic government, is a force for stability and good (see Down With Democracy! and Interventionism Leads To War, War Generates More Intervention-ism); consumer and investor "confidence" and other psychobabble overcomes eroded capital and meagre savings (see GDP and Consumer Confidence in Australia);

Two corollaries follow from these points:

> *First, risk has as much to do with the attitude, disposition and behaviour of the investor – including the over-optimism of his assumptions – as it has with the characteristics of the investment under consideration. Second, something that is routinely cited as a risk to investors, namely the short-term volatility of securities' prices, is in actual fact not a risk. Quite the contrary: volatility presents great opportunities to investors.*

Coping With Risk: The Investor's Temperament and "Mr Market"

According to Graham, the difference between an investor and a speculator is not their abstract conception of risk, but their concrete attitude towards the prices of securities.[6] The speculator, who ignores risk and thus subjects himself to much more risk than he knows, regards value and price as synonyms. He tries to anticipate and profit from short-term fluctuations of prices. The investor draws a clear distinction between price and value. Because he pays attention to the volatility only to the extent that it enables him to acquire securities at reasonable or bargain prices, he can focus his attention upon risk. Value investors bear the distinction between value and price constantly in mind, and therefore possess a distinct temperament. However intelligent they are, individuals who can't master their emotions seldom invest successfully.

Graham used a simple allegory to illuminate these points. Imagine that you and a friend, "Mr Market," are partners in a private business. Each day, Mr Market quotes to you a price at which he is willing either to buy your interest or to sell his to you. The business seems to be solid, reasonably well-managed and has favourable economic characteristics. Mr Market's quotations, however, are anything but stable. On some days they are justified by the firm's characteristics and a rational assessment of its prospects. But on other days Mr Market is exuberant about the business and can see only sunshine and smooth sailing ahead. On these sunny days, fearing that you will try to buy his interest and deprive him of imminent and substantial gains, he insists upon a very high price for his share of the business. Seemingly without rhyme or reason, however, on yet other days he is despondent about the business and its prospects. Seeing nothing but storms and rough seas ahead, and fearing that you will attempt to unload your interest in such an apparently poor business upon him, on these gloomy days he quotes a very low price.

For all his instability and occasional irrationality, Mr Market has an endearing – and very useful – characteristic: he takes absolutely no offence if you ignore

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and deflation presently exists or will soon exist (see Inflation and Deflation: Some Dissenting Thoughts for Value Investors).

6 For details on this and other distinctions between investors and speculators, see Chap. 1 of *The Intelligent Australian Investor* (John Wiley & Sons, 2005).

him. Any transaction is solely at your discretion and if you snub him today, no problem: he will invariably return tomorrow with a fresh quote. If you are a prudent investor-businessman, will you let Mr Market's daily quotations determine your estimate of the business's worth? Hardly. But notice that the more manic-depressive his behaviour – and hence the more volatile his quotes from day to day – the greater are the opportunities which he will present to you. Clearly, you will be happy to sell to him when he quotes to you a ridiculously high price (relative to value), and you will be equally happy to buy from him when he quotes a foolishly low price.

> *The moral of this parable is clear: the prudent investor must remain detached from Mr Market's erratic and sometimes manic-depressive gyrations, form his own ideas and conduct his own analyses. These analyses must ultimately be based upon hard data from company reports and other credible sources.*

Graham warned his students that it is Mr Market's pocketbook – but not his "wisdom" – which is useful. Mr Market exists to serve rather than to guide investors. If he's in one of his moods and quotes a foolish price, you can either to ignore him or to take advantage of him; but disaster will ensue if you succumb to his influence. Mr Graham's students, employees and colleagues took this admonition to heart. In Mr Buffett's words: "the value investor does not look at prices for affirmation, but only to ascertain whether speculators are doing something foolish … if you aren't confident that you can understand and value your business better than Mr Market, you don't belong in the game." To succeed, an investor requires average intelligence and judgment, but a better than average ability to remain detached from the emotional whirlwind Mr Market regularly unleashes. In order to help him retain level-headed and insulated from the constant emotion and occasional absurdity of securities markets, Buffett keeps Graham's allegory strongly in mind.

An Unheralded But Significant Risk

To a Graham-style value investor, the week-to-week and month-to-month volatility of a security's price is not a risk. In sharp contrast, the possibility that, following a bout of frenzy and euphoria, the mood of Mr Market becomes depressed for extended (i.e., multi-year) periods, significantly depressing the prices of most securities, is a significant risk. Warren Buffett, in a series of speeches published in *Fortune* magazine in November 1999, outlined why many "investments" are much more risky propositions than their owners realise – and why investors should reduce their expectations about rewards in the future. So did Chris Leithner in 2005 and 2007.[7]

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[7] See Golden Era or Gilded Age? Inflation and Mean Regression in Australian Stock and Bond Markets, 1965-2006 – and Some Base Rates for 2007-2011 (a paper prepared for the National Investors' Conference of the Australian Investors' Association, 23-26 July 2006, Marriott Resort,

Indeed, for years Austin Donnelly, the dean of financial advisors in Australia, has regarded a sustained bear market as the most significant risk that confronts investors.[8] In his view, planners seldom recognise this risk fully or disclose it properly, and thus cause their clients to suffer financial loss and psychological grief. "Consumers get more protection buying a jar of coffee at the super-market than when investing their life savings … The more frantic the boom, the further markets fall and the longer it will take to recover."[9] A shrinkage of 20% over a 10-year period is a non-trivial possibility at any time; moreover, given the tendency of investment returns to revert to a long-term mean (see Regression to the Mean and Value Investing), this possibility is much higher – and the extent of the decline much more severe – once prices have risen well above any logically or historically justifiable standard of value.

During the mid-1980s and again in the late 1990s, Australians' expectations about their investments became too optimistic. So too from 2003-2007: their outlook, infected with the China and mining fevers, grew dangerously com-placent and divorced from historical reality. Since 2007, reality has reasserted itself. But in one fundamental respect, delusion continues to prevail. It's simply erroneous to believe that major declines of market indices are always short-term affairs. Donnelly concludes that, in order to possess some justifiable assurance of a reasonable return on an investment, a much longer time horizon than is usually recognised – no less than 15 years – is necessary.[10]

Surfers Paradise, Queensland) and Of High P/Es, Low Yields, Raging Inflation and Overstretched Asset Prices.

8 The Crash of 1987 and the bursting of the Internet Bubble and the Great Bubble have revealed to anybody who cares to look that the mainstream's conception of investment risk is absurd. Richard Brealey and Stewart Myers conceded in editions of their influential text published after 1987 that Black Monday posed "some problems." They reassured their readers that "in an efficient market you can trust prices" – but neglected to specify *which* prices, pre- or post-crash, are trustworthy. Prices "impound all available information about the value of each security … in an efficient market there are no financial illusions." So the great unwashed needn't fret: despite the Crash of 1987 and the subsequent bubbles and all the other non-illusions, the orthodoxy remains "remarkably well-supported by the facts" (see Richard Brealey and Stewart Myers, *Principles of Corporate Finance*, 2nd ed., McGraw-Hill, 1984, pp. 266, 272-273; and also its 4th ed. (1991) pp. 297-300, 310.

9 See, for example, "Speak No Evil" by Vita Palestrant (*The Sydney Morning Herald* 29 March 1999). It cited the CEO of the Investment and Financial Services Association: "a lot of what Donnelly is referring to happened decades ago … [I challenge Donnelly] to show evidence in today's market that people are not adequately advised about investment risk." A decade later, has anything changed?

10 Recent events vindicate him. "Investor are bruised and confused after the worst downturn in living memory," reported *The Weekend Australian* (7-8 February 2009), "but almost without exception they are prepared to move back into the stock market when conditions improve." Its investigation revealed that investors "do not expect to see any sign of a sustained recovery for 12-18 months, saying it could take up to three to five years for the market to reclaim the highs struck in late 2007." It sought to convey the impression that investors had been chastened, had learnt lessons and that henceforth their behaviour would be more cautious and their expectations more modest.

Alas, the evidence cited in the article flatly contradicts this intended impression. In the immediate wake of the worst 12-month result in Australian history, investors remained extraordinarily upbeat. How so? To assert that during the next 3-5 years market indices are going to return to the all-time

Leithner & Co.'s shareholders must therefore recognise the long-term risk which attaches to any investment – including the Company's shares:

- slumps have caused losses of 40% or more, with recovery taking up to 15 years;
- in Australia, there have been periods of up to 15 years (and in the U.S. there have been periods of almost 20 years) during which market indices have recorded no inflation-adjusted net gains (see also Leithner & Co.'s Objectives and Possible Returns).

Leithner & Co.'s Conception of Risk Management

Virtually everybody – including institutions, brokers, advisors, journalists and commentators – defines investment risk in terms of the short-term ups-and-downs of a security's market price (relative either to comparable securities or that of "the market" as a whole). As a result, the practice of investment risk management is conventionally understood as an attempt to reduce within acceptable bounds the short-term variability – particularly in a downward direction – of a portfolio's market capitalisation.

Grahamite value investors reject this conventional definition of risk. As a result, hey also reject the mainstream practice of risk management. Alas, few descriptions of value investors' actions subsume them within first principles about risk; and it is even less appreciated that these actions can be derived from simple premises and expressed in terms of a simple but rigorous framework. From a value investor's point of view, risk management is to a significant extent a subjective matter; yet is it hardly arbitrary. Quite the contrary: rigorous statements can be derived about the trade-off among competing risks. *Among the most important (and, for the mainstream, counterintuitive) is that in the absence of better information and the ability to interpret it, investment risk cannot be reduced. Indeed, any attempt to do so tends to increase rather than attenuate risk.*

Total Risk and Competing Risks

Participants in financial markets exchange securities because they expect over time to obtain greater benefit from what they receive than from what they must give in return (see also What Is Value, Anyway?). Trade occurs, in other words, only if each party to the exchange perceives that the (subjective) value of what is received exceeds the (objective) price that is paid. Clearly, however, these perceptions may be mistaken. Risk thereby accompanies any decision to invest. Stripped of its complexities, risk is the probability that a decision does

highs reached in late 2007 is to assert that the indices will rise by 19.5% per year for the next four years. Is there any precedent fort such a persistent advance? Just one: the Great Bubble of 2003-2007! What's the probability that it will recur? If an historically-average return henceforth applies (see Leithner & Co.'s Objectives and Possible Returns), then the All Ordinaries will require ten years – that is, until early 2019 – to rescale the summit it first climbed in late 2007.

not yield its expected results ("good things") and instead produces undesirable, unforeseen and unintended consequences ("bad things"). Investment risk is the likelihood that an investment made today causes a particular "bad thing" – namely, a loss of capital – to occur at some point in the future.

Implicit in this conception – which clearly has nothing to do with the short-term volatility of a security's market price – are *analytic* (estimation of probability), *empirical* (observation of outcome) and *normative* (evaluation of a result as good or bad) aspects. Perhaps a particular investment decision overestimates an asset's ability to generate some stream of earnings; perhaps too much is paid for those earnings; or perhaps some combination of these two errors occurs. It follows that the key to an appreciation of risk – and thus to the ability to make justifiable decisions in the face of uncertainty – is the ability to:

- partition *total risk* (i.e., the overall likelihood that bad things of one kind or another might occur) into a set of *specific risks* (i.e., the individual bad things that might occur);
- prioritise these specific risks.

These specific risks necessitate tradeoffs. To sell all of one's shares and bury the cash in the back garden, for example, eliminates the possibility that one type of "bad thing" (namely the bankruptcy of the underlying businesses, evaporation of their stream of earnings and total loss of capital) occurs. To take this decision, however, necessarily creates the possibility that other "bad things" occur (namely that the cash is stolen, that a pile of $x of cash will over time generate a smaller stream of earnings than a portfolio of $x of common stocks, etc.). The challenge is (relatively objectively) to identify the total risk at hand and (much more subjectively) to choose among a set of competing risks.

"Frequentist" and "Subjectivist" Probabilities

Some risks can be calculated with reasonable, and in some fields very high, degrees of retrospective accuracy. Their calculation depends upon the existence of uniform and thus very similar events, large amounts of valid and reliable data and long periods of comparable past experience. It also presupposes agreement with respect to certain auxiliary assumptions and mathematical techniques. Notable examples are the theft of property and the incidence of injury, mortality and morbidity – and hence life, property and casualty insurance rates. *Frequentist probabilities* are the bread-and-butter of the actuarial and insurance industries.

Other risks, however, can either be estimated only with far higher degrees of subjectivity or cannot be calculated at all. Several reasons underlie this difficulty: the events under consideration are regarded as unique rather than general and comparable; they may be difficult to observe and record accurately;

or they may occur very rarely. For these or other reasons, valid and reliable data from long periods of past experience are not available. Further, consensus with respect to auxiliary assumptions and appropriate mathematical models may not exist. Earthquakes and business operations more generally are examples. As a result, it is much easier to insure your life against loss than it is to insure your business against bankruptcy. In the absence of frequentist probabilities, *subjective probabilities* must suffice. To assume that a given event is imperfectly predictable, one must know quite a lot about it – enough to gather extensive statistics about similar events. But in many situations that we face in the real world of economics and finance, humility (perhaps imposed by bitter experience!) forces us to admit that we cannot be sure how much we know and how much remains that we do not know. This is uncertainty.[11]

The Law of Large Numbers

The Law of Large Numbers, which links theoretically derived frequentist probabilities to their actual frequency of occurrence in the real world, is a pillar of statistical theory. It tells us that in an infinitely large number of repeated, independent trials of a given event, the frequency with which we observe the event will coincide with the theoretical frequency of its occurrence. If, for example, our "event" consists of 500 tosses of a fair coin and we repeat this event a very large number of times under identical conditions, then the average observed frequency of "heads" per event will approach 250, the average percentage of heads will approximate 50% – and the long-run probability of observing heads will approach 0.5. Further, the greater is the number of comparable tosses which comprise an event and the greater is the number of times we repeat the event, the more closely our observed results will approximate their frequentist probabilities.

Two implications follow from this law. First, if one repeatedly takes "bad risks" (if, for instance, one crosses the Nullarbor without water in January or climbs Mt Kosciusko in shorts in June), plays unfavourable games (buys lottery tickets, bets at the races or plays in casinos on any day of the week ending in "day") or undertakes unethical or illegal practices, then – although the result on any given occasion is uncertain and need not produce a loss – it is very likely that a "bad" outcome will eventually be incurred. Indeed, the more often and longer these actions are undertaken, the greater the likelihood that a loss will eventually occur. Second, if one repeatedly takes "good" risks or undertakes "good" practices then over time desired results will tend to be achieved and the losses borne along the way will tend to be relatively small.

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[11] Referring back to footnote 1, a subjective probability attempts (crudely) to quantify the chance that an uncertain (and hence unpredictable through statistical methods) event occurs. According to Rothbard, "Most uncertainties … are unique cases facing each individual or business; they may bear resemblances to other cases, but are not homogeneous with them. Individual entrepreneurs know something about the outcome of the particular case, but not everything."

In a market economy, investors must unavoidably act in the face of what is at best imperfect predictability and what is usually uncertainty. Accordingly, their behaviour is to a considerable extent subjective. This does not mean that it's arbitrary; it means that different individuals will estimate different probabilities of loss with respect to particular courses of action, and will be prepared accept different likelihoods and magnitudes of loss. It also implies that some people possess a particularly well-developed ability to make justifiable and ultimately successful investment decisions. Most importantly, Grahamite investors understand that if one repeatedly selects "good" risks, undertakes "good" practices, avoids "bad" risks and eschews "bad" practices, then one is likely to achieve "good" results and mitigate the impact of "bad" events.

The Futile Hunt for "Minimum Risk"

Given the information to hand at a particular point in time, the overall risk which inheres in a series of decisions cannot be minimised or even reduced. In this critical respect, risk cannot be "managed." Moreover, poor choices borne of faulty premises, invalid reasoning and unreliable evidence can increase total risk and thereby magnify the likelihood of loss. With the information at her disposal, the best the investor can do is to exchange a specific risk that is regarded most undesirable for another regarded as less intolerable. It is only in this limited respect that risk can be "managed." Not just objective consequences but also ethical considerations are thus bound inextricably into the investor's decisions.

As an example, consider a man who is accused of a serious criminal offence and undergoes trial by jury. Clearly, he is either guilty or innocent. Seldom, however, can complete and incontrovertible evidence be brought to bear in order to decide a criminal matter. Accordingly, members of the jury must evaluate imperfect and incomplete information that is put to them indirectly by the prosecution and defence. Influenced by such evidence, they must then deliberate and render a judgement about the defendant's guilt or innocence. Innate uncertainty, combined with incomplete and imperfect information and the possibility that this information is presented and interpreted erroneously, thereby ensures – despite their best intentions – that some percentage of juries' verdicts has always been, is presently and will always be mistaken.

Setting aside mistrials, hung juries and the like, in any given trial the jury must either convict or acquit. Four possible outcomes, set out in Table 1 (p. 12), therefore present themselves. Two are usually regarded as "good": a guilty defendant is convicted and an innocent defendant is acquitted. The third, in which a guilty party is acquitted, is usually regarded as "bad." And the fourth, in which an innocent one is convicted, is (given the presumption of innocence which underlies the Anglo-Saxon trial by jury) regarded as even worse. Two specific risks thus accompany any jury's verdict. The first is the possibility that

it acquits a guilty defendant (thereby leaving a crime unpunished and its perpetrator free to commit further offences). The second is the possibility that it convicts an innocent defendant (thereby depriving the defendant unjustly of his liberty and leaving the culprit at large to commit further offences).

Table 1: The Jury Process:
Four Possible Outcomes and Two Inherent Risks

	Jury …	
Defendant Is …	**Convicts**	**Acquits**
Guilty	Outcome #1: "Good"	Outcome #3, Risk #2: "Bad"
Innocent	Outcome #2, Risk #1: "Worst"	Outcome #4: "Good"

Consider now a thought experiment that comprises one jury, 100 defendants and a series of trials that tries each defendant. Let us say that you are perfectly omniscient, are not a member of the jury and have no contact with its members. You know which of the 100 defendants is guilty and which is innocent, but you cannot give jury members the benefit of this knowledge. Let us also say that 50 defendants are guilty and 50 are innocent, that (by sheer coincidence) the jury's conviction rate across the 100 trials is 50% and that it is able to ascertain the guilt or innocence of any particular defendant with 75% accuracy. The results of your and the jurors' decisions, if they were repeated over a large number of "experiments," each comprising 100 jury trials, would approximate those set out in Table 2. As an omniscient observer, your decisions (the cells of the table labelled "100% Accurate") would correctly identify each of the 50 guilty defendants and correctly "convict" them; similarly, you would correctly identify each of the 50 innocent defendants and correctly "acquit" them.

Table 2: Expected Risks Arising from 100 Jury Trials
With a 50-50 Conviction Rate

	Jury Convicts	**Jury Acquits**	**True Totals**
Guilty Defendants	50 (100% Acc) 37.5 (75% Acc)	0 (100% Acc) 12.5 (75% Acc)	50
Innocent Defendants	0 (100% Acc) 12.5 (75% Acc)	50 (100% Acc) 37.5 (75% Acc)	50
Jury's Total	50	50	100

The members of the jury, however, are fallible. For the 100 defendants as a whole, the jury's 50-50 conviction rate (bottom row) happens by a happy coincidence to correspond exactly to the true numbers of guilty and innocent defendants (fourth column). With respect to individual defendants, however, either because perfect and complete information is not put to them, they misinterpret it or they let biases prejudice their judgement, the jurors make mistakes. Given the jury's accuracy rate (labelled "75% Accurate" in the Table),

on average it will correctly convict 37.5 of the 50 guilty defendants but erroneously acquit the other 12.5. Similarly, on average it will accurately acquit 37.5 of the 50 innocent defendants but mistakenly convict the other 12.5. As a result, the two risks identified in Table 1 come to fruition: one-quarter of the defendants (12.5 + 12.5) are either wrongly convicted or wrongly acquitted.

Assume now that another series of 100 jury trials, using the same jury, takes place. Before the first trial begins, however (perhaps on the basis of new evidence, a confession or some other development), one or more of the wrongful convictions in Table 2 comes to light and is overturned. The jury, being human, is chastened. It cannot know with absolute certainty which of the 100 new defendants is guilty and which is innocent. But in order to lessen the likelihood that it wrongfully convicts an innocent man, it decides to raise the bar against wrongful conviction by reducing its willingness to convict.

Let's say that it lowers its overall conviction from 50-50 to 40-60. All else, however, remains equal: you are omniscient, 50 of the defendants are guilty and the jury's accuracy rate remains at 75%. The results of your and their decisions, if taken under these assumptions over a large number of sequences of 100 trials, would approximate those set out in Table 3. As an omniscient observer, your decisions continue to identify correctly each of the 50 guilty defendants and correctly to "convict" them; similarly, you continue to identify correctly each of the 50 innocent defendants and correctly to "acquit" them.

Table 3: Expected Risks Arising from 100 Jury Trials
With a 40-60 Conviction Rate

	Jury Convicts	Jury Acquits	True Totals
Guilty Defendants	50 (100% Acc) 30 (75% Acc)	0 (100% Acc) 20 (75% Acc)	50
Innocent Defendants	0 (100% Acc) 10 (75% Acc)	50 (100% Acc) 40 (75% Acc)	50
Jury's Total	40	60	100

Again, however, the members of the jury are not omniscient. With respect to the individual defendants, then, the jurors will continue to make mistakes. Given their 40-60 conviction rate they convict 40 defendants; and given their 75% accuracy rate 30 of these 40 are accurately identified as guilty. They thereby correctly convict 30 of the 50 guilty defendants – and erroneously acquit 20 others. Analogously, they correctly acquit 40 of the 50 innocent defendants but mistakenly acquit 10 guilty ones.

The lower conviction rate, given an unchanged number of guilty and innocent defendants, thus has two consequences. It causes the sum of the two risks – average total risk – to increase from 25 (12.5 + 12.5 in Table 2) to 30 (10 + 20 in Table 3). It also causes the distribution of the two risks to change. The jury tends wrongfully to convict fewer innocent defendants – 10 in Table 3 versus

12.5 in Table 2 – and thereby mitigates the extent of Risk #1 (the "worst outcome" identified in Table 1). At the same time, however, it tends wrongfully to acquit more guilty defendants – 20 in Table 3 versus 12.5 in Table 3 – and thus exacerbates the extent of Risk #2 (the "bad outcome" in Table 1).

> *The jury, in other words, makes a subjective "trade-off" whereby one risk which many people regard as more ethically undesirable is "exchanged" for another which many regard as less undesirable. But this exchange comes at the cost of more mistaken verdicts.*

Another conclusion emerges. Over the longer term, the only means whereby jurors can reduce the total risk that inheres in their decisions is to increase the average accuracy of their decisions. This, in turn, implies either: an increase in the quality and quantity of the information to which they have access; an improvement in their ability to interpret this information; or a reduction in the psychological biases which mar their judgement.

Constructing and Managing Portfolios

Let us now derive a simple framework with which to construct and manage an investment portfolio. From a mainstream point of view, its results are startling:

> *Given the information available at a particular point in time, the overall risk present in a series of decisions cannot be minimised or even reduced; but poor choices can increase total risk and thereby magnify the likelihood of loss.*

Without better information and the ability to interpret it (which can reduce overall risk), the best that the investor can do is to "exchange" one risk regarded as most undesirable for one regarded as less undesirable. Clearly, then, subjective and ethical considerations are bound inextricably into the construction and management of an investment portfolio.

Investing: Four Possible Outcomes and Two Inherent Risks

Imagine that you are a one-person "jury" and that you must evaluate a security as a potential addition to your portfolio. It either will or will not generate the stream of earnings that your assumptions and analysis ascribe to it; and it either is or is not available at a sensible price. Accordingly, it either is or is not suitable for your purposes. Clearly, however, evidence from the past and present never shed incontestable light upon the results that a potential investment will achieve in the future.

Adding to the difficulty is delayed feedback – only in several years' time will its (un)suitability become apparent. You must therefore decide using imperfect and incomplete information about the past and present. You must also make

assumptions about an imperfectly predictable and perhaps uncertain future. As a result – and despite your best intentions and self-interest – the odds are pretty well Buckley's that none of your investment decisions will be mistaken.

Assume that in five years it will be apparent whether this particular investment opportunity is sound. The trouble is that you must decide today whether to act upon it. Four possible outcomes (Table 4) therefore present themselves. Two are usually regarded as "good": a sound investment opportunity is grasped and an unsound one is avoided. The third outcome, in which a sound opportunity is declined, is "bad." And the fourth, where unsound investment is purchased, is even worse. Table 4 therefore shows that two risks accompany every investment decision. The first is a *sin of omission*. This is the possibility that a sound opportunity is declined. The second is a *sin of commission*, i.e., the possibility that an unsound investment is grasped and a loss eventually incurred.

Table 4: The Investment Process:
Four Possible Outcomes and Two Types of Risk

	Today It Was Decided…	
In Five Years' Time It Is Apparent That the Investment Opportunity Was …	**A. To Invest**	**B. Not to Invest**
1. Sound	Outcome I: A Good Investment Decision	Outcome III, **Risk II:** A Bad Non-Investment Decision (i.e., Sin of Omission)
2. Not Sound	Outcome II, **Risk I:** A Very Bad Investment Decision (i.e., a Sin of Commission)	Outcome IV: A Good (Non-Investment) Decision

Thought Experiment #1

Consider now a thought experiment that includes you, 100 potential investments, 100 decisions and me. Let us say that you are perfectly prescient: your crystal ball can gaze five years into the future and determine with perfect precision which of the opportunities is (for my purposes) sound and unsound. Unfortunately for me, however, you do not give me the benefit of your knowledge. Assume that 50 opportunities are sound and 50 are unsound, that my "accuracy rate" is 50% (i.e., my assumptions and analysis can ascertain the soundness or otherwise of each opportunity with 50% accuracy) and that my "acceptance rate" is also 50% (i.e., given an assessment of a sound opportunity, the likelihood that I act upon it is 50-50).

The results of our investment decisions, if they were repeated over a large number of experiments, would approximate those set out in Table 5 (p. 16). As an omniscient observer, your decisions (the cells of the table labelled "100% Accurate") would correctly identify each of the 50 sound assets and correctly

"purchase" them; similarly, they would correctly identify each of the 50 unsound assets and correctly refrain from "buying" them.

But my decisions, remember, are fallible. At the aggregate level, the true numbers of sound and unsound assets (fourth column) correspond exactly to the total numbers that I actually buy and decline to buy (bottom row). With respect to individual investment decisions, however, I make mistakes. Given that each of my decision is, on average, 50% accurate (labelled "50% Accurate" in the table), I will tend correctly to purchase 25 of the sound investments but erroneously decline to purchase the other 25. Similarly, on average I will rightly decline to purchase 25 of the 50 unsound investments but mistakenly buy the other 25. As a result, the two investment risks come to fruition: one-half of the assets (25+25) are either wrongly purchased or wrongly declined. My results under these circumstances are no different from those that would occur if I simply tossed a fair coin.

Table 5: Expected Risks Arising from a Series of Investment Decisions With a 50-50 'Acceptance Rate' and a 50-50 'Accuracy Rate'

	Five Years Ago It Was Decided …		
Today It Is Apparent That the Investment Opportunity Was …	**A. To Invest**	**B. Not to Invest**	**True Totals**
1. Sound	50 (100% Acc) 25 (50% Acc)	0 (100% Acc) 25 (50% Acc)	50
2. Not Sound	0 (100% Acc) 25 (50% Acc)	50 (100% Acc) 25 (50% Acc)	50
Investor's Total	50	50	100

Thought Experiment #2

Assume that five years later I am faced with another series of 100 investment decisions. Given the results in Table 5, I am chastened. I cannot be certain which of the 100 new opportunities is sound and which is unsound. During the past five years, however, I have learnt that if the "acceptance rate" is decreased then the expected number of dud investments in a portfolio can be reduced. Let us say that I lower this rate from 50-50 to 20-80. I have also realised that one can cut the total risk in a series of investment decisions by increasing the average accuracy of each decision. I have therefore increased the quality and quantity of the information that I use to make decisions; improved my ability to reason through and interpret this information; and reduced the extent of the psychological and other biases that mar my judgement. Let us say that these improvements have increased my average accuracy from 50% to 75%. Otherwise all else remains equal: you are omniscient and 50 of the 100 investment opportunities are sound.

The results of our decisions, if taken under these assumptions over a large number of sequences of 100 trials, would approximate those in Table 6. As an omniscient observer, you continue to identify each of the 50 sound investment opportunities and to act upon them; similarly, you continue to identify each of the 50 unsound investments and to avoid them. Again, however, I am not omniscient. Note that at the aggregate level my 20-80 acceptance rate (bottom row) no longer corresponds to the true numbers of sound and unsound investments (fourth column). Further, I continue to make mistakes. Given my more stringent acceptance rate, I act upon just 20 opportunities; and given my 75% accuracy rate, 15 of these 20 are assessed correctly. I thereby invest correctly in 15 of the 50 sound investments – and mistakenly forego 35 others. On the other hand, I correctly avoid 45 of the 50 unsound opportunities and mistakenly accept the other 5.

Table 6: Expected Risks Arising from a Series of Investment Decisions With a 20-80 "Acceptance Rate" and 75% "Accuracy Rate"

	Five Years Ago It Was Decided …		
Today It Is Apparent That the Investment Opportunity Was …	**A. To Invest**	**B. Not to Invest**	**True Totals**
1. Sound	50 (100% Acc) 15 (75% Acc)	0 (100% Acc) 35 (75% Acc)	50
2. Not Sound	0 (100% Acc) 5 (75% Acc)	50 (100% Acc) 45 (50% Acc)	50
Investor's Total	20	80	100

Under the assumption of a much lower "acceptance rate" and a higher "accuracy rate," in other words, I will tend to accept far fewer unsound investment opportunities and thereby commit far fewer "sins of commission" (5 in Table 6 versus 25 in Table 5). I will also tend to forego more sound opportunities (35 in Table 6 versus 25 in Table 5) and thus commit more "sins of omission." The distribution of the two competing investment risks thus changes substantially: there is a decrease in the occurrence of real financial losses and an increase in the forfeiture of hypothetical financial benefits.

> *In consequence, the ratio of "sound" to "unsound" investments in my portfolio increases from 1-to-1 (i.e. 25:25) in Table 5 to 3-to-1 (i.e., 15:5) in Table 6. At the same time, however, given better standards of analysis and more stringent criteria of decision-making, total investment risk – that is to say, my total number of erroneous investment decisions (25+25 in Table 5, 5+35 in Table 6) – falls from 50 to 40.*

The Rosetta Stone

As with jury decisions, then, so too with the management of risk: the major difference between Tables 5 and 6 is that a subjective "trade-off" of risks has

occurred whereby fewer dud investments are purchased but more sound ones are overlooked and foregone. One risk which Grahamite value investors regard as completely intolerable, in other words, is willingly traded for another they regard as undesirable but nonetheless bearable. Here, then, are two characteristics of Grahamites' thinking and behaviour. The first (the *acceptance rate*) denotes the extent to which they prioritise their options and act only upon those which appear to have the best odds of achieving their intended long-run consequences. The second is the *accuracy rate* of successful decisions. This is the extent to which the investor can ascertain whether a particular security's price is significantly lower than a subjective but justifiable estimate of its value.

Value investors strive to use logic and evidence to identify discrepancies between prices and values, to act only upon the widest incongruities – and thereby to increase their decisions' overall *accuracy rate*. Concentrating their portfolios upon the widest discrepancies tends to reduce their *acceptance rate*. Their assumptions, analyses and behaviour thus tend cumulatively to create what Graham called a *margin of safety*.

The Acceptance Rate, Concentration and Diversification of the Portfolio

Grahamite investors are selective investors. Graham's employees at Graham-Newman Corp. often recounted the number of times they put investment proposals to their boss and the number of times he rebuffed them. Graham accepted few of the "opportunities" that came his way. Value portfolios are therefore concentrated in the sense that they consist exclusively in assets that (at least at the time of purchase) possess a healthy margin of safety.

Yet value portfolios are also diverse. They tend to comprise a heterogeneous collection of securities that possess a reasonable margin of safety. Moderate diversification and hefty margin of safety go hand in hand. Even if a particular investment opportunity seems to possess a healthy margin of safety, it may nonetheless end badly. The margin implies only that the opportunity has a better chance for profit than for loss: it hardly precludes the possibility of loss. As the number of such seemingly favourable investments in a portfolio rises, the more likely it is that the aggregated results of correct choices will exceed those of poor ones. As a rough-and-ready rule of thumb, Graham reckoned "if such a margin is present in each of a diversified list of twenty or more stocks, the probability of a favourable result under 'fairly normal conditions' becomes very large."

The Accuracy Rate and the Margin of Safety

Graham emphasised that the margin of safety rests upon simple and definite numerical reasoning from statistical data. Grahamite value investors are therefore a relentlessly logical and analytical lot (but like the economists of the

Austrian School, they distrust arcane calculations, models and the spurious precision they convey). They strive to maximise the accuracy rate of their investment decisions, i.e., the extent to which they are able consistently to ascertain whether a security's price is significantly lower than a cautious estimate of its value.

How do they try to do this? First, they strive to increase the quality and quantity of their information. In practice, they consume primary information (i.e., raw statistical data, company financial statements and so on) voraciously, and they either discount or ignore secondary information which has been mediated by brokers, advisors, analysts and journalists. Second, they seek to improve their ability to interpret information. Finally, they attempt to identify and reduce the psychological and other biases (such as the adherence to mainstream economics and finance) that mar judgement.

"Thus," said Graham, "in sum we say that to have a true investment there must be present a true margin of safety. And a true margin of safety is one that can be demonstrated by figures, by persuasive reasoning, and by reference to a body of actual experience." He concluded "the wise men boiled down the history of mortal affairs into the single phrase 'this too shall pass.' Confronted with a like challenge to distil the secret of sound investment into three words, we venture the motto 'margin of safety.' This is the thread that runs through all the preceding discussion of investment policy."

At Last: the Frank Disclosure of Real Risk in Plain English

The Possibility of Loss

We're now in a position to summarise the risks of owning Leithner & Co.'s shares. Just in case you missed it on p.3, we repeat this vital injunction:

> *Each class of investment has certain characteristics; and within each class, each individual investment has its own advantages and disadvantages. Because Leithner & Co. is a business which in turn is a part-owner of other businesses, the returns from the ownership of its shares should be regarded as less certain than those which derive from residential or commercial real estate, Commonwealth bonds or bank deposits.*

It's also important to emphasise a point made in Leithner & Co.'s Objectives and Possible Returns (p. 19):

> *It's not reasonable for shareholders to expect exceptional (or even above-average) results from their investment. They should always remember that regression to the mean or something very similar to it exists in financial markets. Investment operations, including those undertaken by LCO, are*

> *inherently risky. Its results in the future will certainly fluctuate, losses may be incurred and the results of the past are not reliable indicators of what might transpire in the future. As the vital phrase goes, "past performance does not guarantee future performance."*

A third point is that in a real recession the prices of most securities will fall – week after week and month after month. During a bracing recession, you'll want tear your hair out (unless you've already gone bald from worry) and the Directors of Leithner & Co. will want to hide under their desks and tremble whenever they receive telephone calls and e-mail messages. In a masculine recession (as opposed to the girly version of the early 2000s), you will be angry, but your anger will be utterly pointless. Even if Thomas Jefferson, the greatest economists of the Austrian School, Mahatma Ghandi, Albert Einstein, John Lennon, Ron Paul or Merlin the Magician managed your assets, it wouldn't matter. Recessions and bear markets show no respect for people and reputations. Accept this reality. If you cannot, then don't invest in Leithner & Co.

The Certainty That Government Is Evil

It's as predictable as the sun rising in the morning: politicians are one-third dreadful, two-thirds (more or less) laughable and precisely three-thirds contemptible. They are inherently incompetent; that is, their interventionist policies necessarily fail (for details, see the introduction of *The Intelligent Australian Investor*, John Wiley & Sons, 2005). At best, they are pompous fools; normally they are bungling thieves; and at worst they are ruthless mass murderers (for details, see Who Shalt Not Steal? Who Shalt Not Kill? and Down With Democracy!). From one point of view, Australia is a "two-party system." There is an evil party (the ALP) and a stupid party (the Liberal-National coalition). Quite often, and these days rather routinely, they unite in order to do things that are both stupid and evil. This is called bipartisanship. From another point of view, "Labor" and "Coalition" are indistinguishable; they're merely the two wings of a single bird of prey – which feasts upon taxpayers. Clearly, the primary threat to Australians' liberty and prosperity comes not from abroad, but from the caste of criminals in Canberra.

If you or I commit theft, it's called stealing and is rightly condemned. But when the agents of the state steal, it's called "taxation" or "fiscal policy" or "redistributionist policy," is hailed as a bulwark of "social justice" and its proponents are lionised as "compassionate." If you or I counterfeit, it's called fraud and is rightly punished; but when central bankers do it, it's called "monetary policy," is applauded as an essential condition of financial and economic stability and its conjurers (like Alan Greenspan) are deified. And if you or I commit mass murder, we're rightly loathed and damned. But when politicians and military commanders order their henchmen and underlings to shoot and bomb, it's called "foreign policy" and its practitioners are celebrated as heroes.

Is there one moral code for private people and businesses (which forbids theft, fraud and murder), and a diametrically different one for the agents of the state (which requires stealing, counterfeiting and killing)? The evil Richard Nixon asserted in 1971 that "when the President does it, that means that it is not illegal." Do you agree? If not, then logic forces the conclusion that government is evil (for details, see The Ethics of Liberty by Murray Rothbard and Our Enemy, the State by Albert Jay Nock). Do you believe that politicians have information, expertise or wisdom that the rest of us don't, or that they act in the "public interest"? If so, then we respectfully submit that you have rocks in your head. Want to save a whale? Then buy one with your own money! Want a handout? Go inherit your own fortune!

Unconventional Behaviour Can Be Prudent

From the Non-Aggression Axiom and a handful of other *a priori* propositions springs the Austrian School of Economics; and the Austrian School, together with the value school of Benjamin Graham, forms the foundation of our operations (for details, see Ludwig von Mises, Meet Benjamin Graham: Value Investing from an Austrian Point of View). What does this imply? First, thanks partly to governments' relentless destruction of the purchasing power of fiat currencies, the long-term bias of the nominal prices of stocks, real estate, etc., is indeed upward. Secondly – and thanks mostly to governments' and central banks' myriad other interventions in the economy, which unleash the boom which causes the bust – stocks, bonds and real estate occasionally crash. Sudden plunges and extended bear markets go with the territory. In short, Graham and Mises counsel us to expect misfortune, and to endure it when it knocks on the door. If you can't, deposit your funds in a bank. But if you take this route, don't complain to us that the inflation manufactured by the central bank is trashing the deposit's purchasing power, or that your bank is teetering on the edge of insolvency. At some point in his life, almost everybody experiences financial misfortune.

If it hasn't occurred to you by now that Leithner & Co. is an unconventional organisation, then please stop reading. Aside from the foregoing points of anodyne and boilerplate terrorising (notice that we have graciously spared you the usual pretty graphs, glossy paper, self-congratulatory prose and photos of young, well-dressed and photogenic women),[12] there are specific and perhaps unique risks that attach to Leithner & Co. You should understand them before you consider buying its shares. Since most people don't take risk and uncertainty seriously (this doesn't mean *you*, of course, just all *other* potential investors), we thought we'd try more innovative means to scare you.

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12 The graphs are usually biased towards good results, and are therefore misleading; the paper is needlessly expensive; and the prose is as idiotic as it is soporific. The Directors of Leithner & Co., who are ugly, admire young and photogenic women as much as anybody; but in an investment context such photos are utterly beside the point.

In the past we have bought – and in the future may well buy – seriously unpopular stuff. The stuff that nobody else wants to touch. Since the onset of what the mainstream has dubbed the "Global Financial Crisis" (and what we regard as the consequence of Western governments' economically illiterate and criminally insane policies of interventionism), we have concentrated upon securities that virtually all others regard as anathema. When the crowd panics, the prices of a few securities fall to levels that are far lower than even our dour estimates of their value. Thus far, these investments have sorely tested our digestive systems, but most have rewarded our patience. Obviously, in the future we may not be so fortunate. (By the way, the use of "we" and "our" is a euphemism for *you*, got it?)

In a second sense, Leithner & Co. has acted highly unconventionally. (The approval of the majority might make an action conformist, but that hardly makes it justifiable. We believe that our unusual thinking and actions have actually been prudent.) Since 1999, as the prices of most securities have levitated ever further above their values, cash and its rough equivalents has comprised an ever greater percentage of our assets (see Graph 1 in Objectives and Possible Returns). This has moderated the volatility of our results. But we suffer when the rates of interest paid on cash plummet. Further, since rising rates – yes, Virginia, the bailouts, handouts, deficits and other crazy policies of today will beget higher rates down the track – tend to place downward pressure upon all valuations, we could also get clobbered when the clowns at the RBA raise the OCR, or the economy shows that it's beyond the control of those who think that they're in control, and Australia ceases to be the Lucky Country and sinks into the deep blue sea.

You Decide Whether Our Premises and Reasoning Make Sense

So now you know. Don't come crying to us if we lose all of your money, and you become a Dumpster Dude eating dog food or a Trolley Lady collecting aluminium cans. You're an adult, so think and act like one. Don't say you haven't been told. If we haven't chastened you enough or dissuaded you from investing at least $250,000 with us, please e-mail us (info@leithner.com.au) and we'll try something else. Alternatively, contact almost any financial planner. We're not on any list of "approved products" (we're far too unconventionally prudent), so they'll certainly steer you away from us and probably (there are some honourable exceptions) into something that's conventionally risky and pays them a nice commission.

Chris Leithner
2 March 2009