An Enduring Approach to Risk Management

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The topic of risk is becoming more common in investor conversations. Given the tumultuous events of the last 18 months, this increase is understandable. In addition to the pandemic, investors have been introduced to cryptocurrencies, meme stocks, and the rising threat of inflation. However, the concept of risk is often misunderstood by market participants, which can create its own risks.

Over the last three decades, investors have been conditioned to define risk as being different than the broader market or deviating from a stated benchmark. This movement has not served investors well. In an effort to reduce their risk under this definition, many active managers have positioned their portfolios to more closely approximate their respective benchmarks. This convergence in portfolio construction has resulted in some investors paying active management fees for index-like performance. It also reduces the manager's ability to distinguish their skillset.

Yet perhaps the most damaging result of this confluence of active and passive management is that investors often do not appreciate the risks they are taking. Defining risk against an index assumes that the index is a low-risk option. Yet contrary to popular opinion, many indices possess high degrees of risks. These risks include an inherent momentum bias in market cap-weighted indices, concentration risk, and even investability risk. These benchmark risks are accentuated in the smaller cap indices whereby a substantial portion of the index may be invested in highly speculative areas of the market. Oftentimes, more than one-third of the smaller cap indices are invested in companies that are not profitable. These risks create outsized volatility that make it difficult for the average investor to weather market storms and resist making emotional mistakes.

Riverbridge approaches risk management much differently. We define risk as the permanent impairment of earnings power. Said another way, we seek to manage the risk that the companies in our portfolios would lose the ability to generate sustainable high returns on invested capital. No part of our research or portfolio construction process is concerned with the portfolio's positioning relative to a benchmark. In our view, this is a feature, not a bug.

Instead, we control investment risk primarily through our fundamental evaluation process. The strategy seeks to invest in companies possessing the ability to produce unit growth and high returns on capital regardless of the overall economic environment. This discipline controls economic sensitivity risk. Additionally, the Riverbridge portfolios invest only in those companies with the ability to internally finance their growth. Unlike many of their counterparts, our portfolio companies are not dependent upon borrowing or selling shares to the public markets to finance their growth. During periods of economic and market turmoil, these disciplines decrease the risk that our portfolio companies would experience permanent loss in earnings power.

Riverbridge also takes a unique approach to diversification. Rather than focusing on sector allocation, we monitor earnings correlation to ensure appropriate diversification. We limit our exposure to a common earnings catalyst to no more than 20 percent of the portfolio. We define earnings catalysts as external factors, beyond management's control, which influence a company's results. There are literally dozens of potential earnings catalysts that we monitor. Just a few examples include weather, commodity prices, interest rates, Medicare reimbursement rates, consumer confidence and behavior, and the book-to-bill rate in the semiconductor industry. Our experience has shown us that typical sector diversification does not adequately mitigate risk. This is because companies in different benchmark sectors may be impacted by the same earnings catalysts, and companies in the same benchmark sector may be impacted by completely different earnings catalysts.

Riverbridge's differentiated approach to risk management has allowed our strategies to generate compelling risk/reward characteristics relative to the market and relative to the benchmarks against which we are evaluated. Since their inception, Riverbridge's portfolios have consistently generated strong absolute and relative returns. Equally importantly, they have not done so by taking outsize risk. Our strategies are generally less volatile than their benchmarks as measured by standard deviation of returns. Furthermore, our portfolios have suffered fewer years with negative returns. The time-tested Riverbridge investment approach continues to deliver a risk profile that helps our clients invest with endurance.