What is risk Anyway: A story of different kinds of leverage

The financial industry has countless ways of looking at risk, many of which we understand, but few we fully agree with. Our definition of risk is simple, we see risk as the chance of a permanent loss of capital. This view however is far from universal. The industry often looks at risk through the lens of share price volatility and deviation from benchmarks. As both metrics are easily retrievable and part of the incentive structure of the industry, it is easy to see why they are so popular. Although popular, we believe they are not aligned with our goal as a fiduciary. Our job is to maximize the long term return of our investors. Volatility and deviations from benchmarks should only be a concern if they result in our clients selling and buying our fund at the wrong points in the cycle. Other than this, risk should be determined by the chance of our underlying investments being impaired. Stocks are not pieces of paper that move around but they represent partial ownership stakes in businesses. In our experience, one of the biggest causes of this risk, is the amount of leverage. Determining how levered an investment is, is more difficult than it may appear at first sight. It is often only when two forms of leverage; operational and financial leverage meet, that the risk of capital being permanently impaired increase significantly.

Leverage has many forms, but it is mostly associated with financial leverage and debt. Investors often assume that the more debt or financial liabilities a firm has, the riskier it is. Many firms however have created significant wealth by employing safe levels of financial leverage. Warren Buffett himself, has created a large part of his wealth by using leverage. He has done so by using the money policy holders entrust to his insurance operation, Berkshire Hathaway. This form of debt is both safe and cheap as policyholders cannot redeem this money even in times of crisis. This is why it is not the absolute level of debt which determines whether an investment survives a downturn, but the way the debt is structured. Often it is not financial leverage itself that causes a permanent loss of capital. A loss tends to only occur when financial leverage is combined with another form of leverage, operational leverage.

Operational leverage is a complicated term for a simple concept. It's a business with high fixed costs. A grocery store is a good example of this. When one owns a grocery store, nearly all the costs are fixed. Rent needs to be paid, the cashiers need to be in place and the food has to be replenished on a daily basis. These costs go on regardless of the amount of sales the store generates. The upside of this, is when sales increase only slightly, profits increase rapidly. The problem with leverage, is that it works both ways. A grocery store may seem like a stable business but this hides an uglier truth. Although customers need to buy goods almost every day the fixed costs of the business mean that if revenues drop marginally, profits may disappear completely.

A hard earned lesson of high leverage was our investment in Tesco, the UK supermarket chain. Tesco had a history of strong growth and high margins combined with a dominant position in their home market. The company had an aggressive growth strategy both in the UK and abroad.
To finance this growth it borrowed more money, and sold off properties only to lease them back later. During this expansion phase profitability remained stable while both operational and financial leverage increased. We believed the company was attractively valued at this stage, but we underestimated how sensitive the business had become to small changes in revenue. The growth of the low cost retailers Aldi and Lidl in the UK pressured Tesco. This resulted a small decline in revenue in the UK of only 1.7%, but an 80% drop in profitability*. What seemed stable on the surface was anything but.

To lower the risk of similar mistakes occurring in the future we now explicitly assess both operational and financial leverage. If companies score highly on both metrics we are hesitant to invest.

Leverage increases the chances of a permanent loss of capital. Determining when safe leverage turns into excessive leverage is not an exact science, and it cannot be assessed by merely looking at historical financial or share price data. While assessing this risks or any other fundamental risk, is not black or white, we believe it does determine the risk our shareholders run.

*Source: tesco Annual report 2015

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