



September 2006

THE TEXAS HEDGE REPORT

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www.texashedge.com

VOLATILITY DOES NOT EQUAL RISK

According to the encyclopedia, the word “volatility” most frequently refers to the standard deviation of the change in value of a financial instrument with a specific time horizon. It is often used to quantify the risk of the instrument over that time period. We do not equate volatility with risk however. In our eyes, “risk” is the chance of a permanent loss of capital. “Volatility” is simply the trading range a stock exhibits in the short run. For example, if an investor finds a company trading through net cash that makes money in a business he understands, then there is very little risk in owning its shares. That doesn’t mean that such a company, particularly if it is an illiquid small or micro cap, won’t be volatile. It could easily trade up or down 30 or 40% on little (if any) news. This volatility is shunned by most, but can be embraced by those investors who use the scary sell-offs to add to positions when everyone else is fearful.

We think that the flight from volatility is often confused with a flight from risk. Just because an overvalued name was in a tight trading range for years, that does not mean it couldn’t get cut in half tomorrow. Let’s look at two examples. The first one is Krispy Kreme Doughnuts (KKD). KKD was a Wall Street Darling when it IPO’d right around the time the stock market peaked. Even after the bubble popped, KKD kept its “cult stock” status and therefore wasn’t dragged down by the general bear market. From late 2001 to early 2004, KKD spent most of its time trading in a tight range around the \$35-40 level. During that time, a few analysts (including your authors) could be heard kicking and screaming about the company’s self-dealing and overexpansion. Nonetheless, KKD was considered a relatively safe stock to own. The average fund manager’s rationale was something like, “I like their donuts, they are a real business unlike dotcoms, and I know lots of smart people who own shares.” Sure enough, when the stuff hit the fan, KKD lost more than three quarters of its value in less than one year!



Deluxe Corp. (DLX) is a similar story. DLX provides checks and other personalized printed products to businesses and consumers. They ran into problems (both operational and financial) when they faced declining check demand and increased customer buying power, and bought back stock at high levels. Through the beginning of 2004, the average investor would have incorrectly assessed risk in shares of DLX because of its low volatility and “old-economy” business. Sure enough, the Street finally caught onto the problems and then stock cratered.



Keeping in mind the differences between “risk” and “volatility” is critical. Absolute long-term performance, particularly during down years in the market is the best measure of conservatism and risk in one’s portfolio.

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