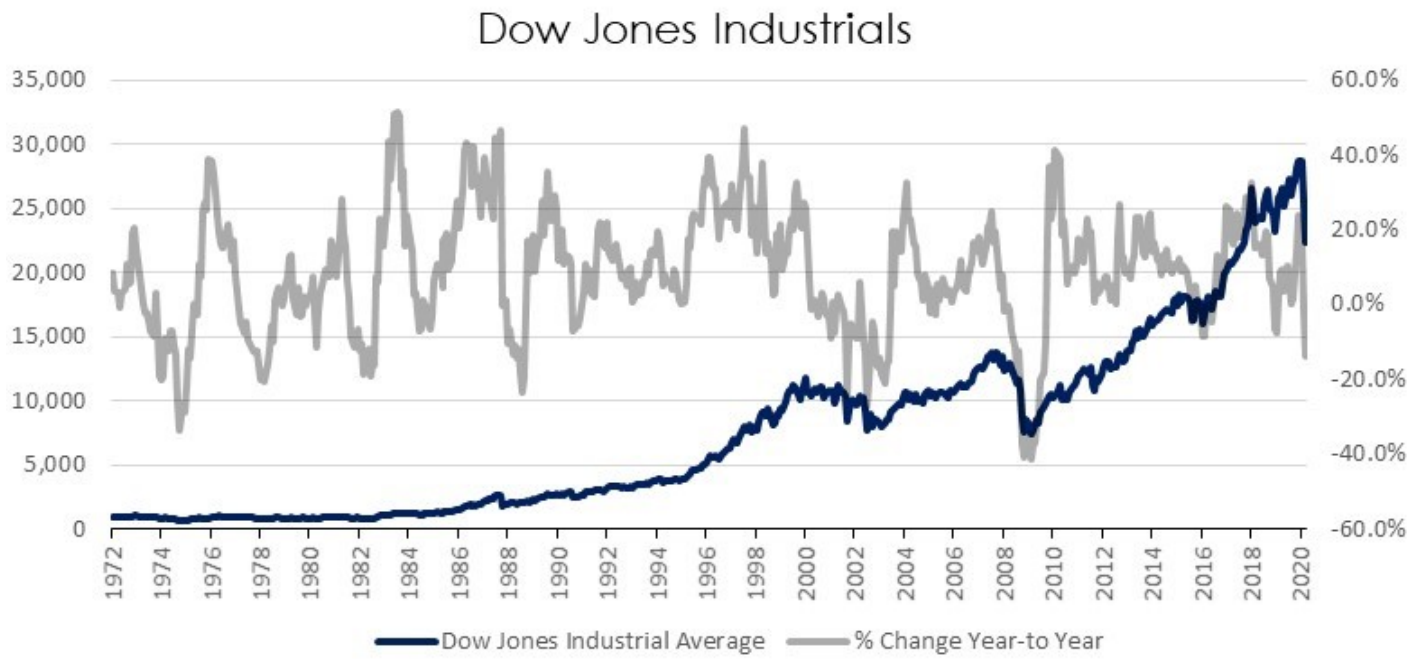
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Volatility vs. Risk

Written by: Paul Kleinschmidt
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Time is the investor's friend and the speculator's foe. Why? One reason is that many market participants tend to confuse risk and volatility. For long term investors (and really, there is no other kind) volatility represents not a true risk, as in complete loss of principal, but an aggravation, and, very often, an opportunity. This is illustrated in the following graph, which depicts the forty-eight-year performance of the Dow Jones Industrial Average against the year-to-year percentage changes in that same index. As can be seen, a patient investor would have done quite well with little absolute risk, while a short-term trader might easily have become financially (and emotionally) unsettled. For patient investors volatility only really becomes a problem when there is an urgent need to sell. This why we consistently urge our clients *not* to invest when they plan to spend their capital over the near to intermediate term.



This notion of volatility as irritation or a phase as opposed to true risk is not to be taken cavalierly in the face of an extraordinary global pandemic. To be sure, there is no real roadmap for where we find ourselves now. Many illiquid businesses will fold, so will many previously liquid businesses. Unemployment has already begun to soar, consumer behaviors have changes and will be permanently altered in some ways. Millennials are now twice bitten by 100-year events since entering the workforce and beginning to save. They are likely to be risk averse for the rest of their lives.

The world that will emerge after the pandemic subsides will, more likely, face a challenging economic recovery, rather than the sharp rebound many investors continue to hope for. But, no one really know what is on the other side of this and no business will go unaffected. Those who proclaim differently shouldn't be trusted.

So, we will have volatility, but volatility, in and of itself, if perceived correctly, it is not inherently bad. In fact, volatility can often be an exceptional opportunity for price sensitive, long term investors to upgrade their portfolios. The essential goal of investing is to earn risk adjusted returns that are superior, over time, to those on risk free assets.

Superior returns come with the assumption of reasonable business risks. In due time we will once again be able to make reasonable assumptions about business risk. In the current circumstances, of course, it is impossible to decipher the near-term earnings *prospects* of most companies, but it is not impossible to ascertain an approximate "through-cycle" estimate of earnings *power* for quality companies with sound balance sheets and unimpaired end markets. Then, one can discount those estimates based on several different scenarios. If fear induced volatility in the market creates a significant gap between the current

price and the intrinsic value derived from such exercises it yields an attractive entry point for long term investors.

“Markets fluctuate,” said Bernard Baruch, and indeed they do. In both directions. Over the long term, that direction has been primarily up.

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WRITTEN BY

Paul Kleinschmidt

President, Chief Executive Officer & Portfolio Manager

Paul J. Kleinschmidt serves as President and Chief Executive Officer and is a Portfolio Manager at Tocqueville Asset Management L.P., where he is responsible for managing customized investment portfolios for high-net-worth individuals, families, and institutions.

Mr. Kleinschmidt joined Tocqueville in 2010, bringing with him a foundation in equity research and investment strategy. Prior to his tenure at Tocqueville, he worked as a securities analyst at Argus Research in New York City, where he focused on industrial and transportation sectors. He began his investment career at Clareville Capital Partners LLP, a London-based hedge fund, where he served as a research analyst supporting the firm’s UK and European investment initiatives.

Mr. Kleinschmidt holds a B.A. degree in Economics from Denison University.

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