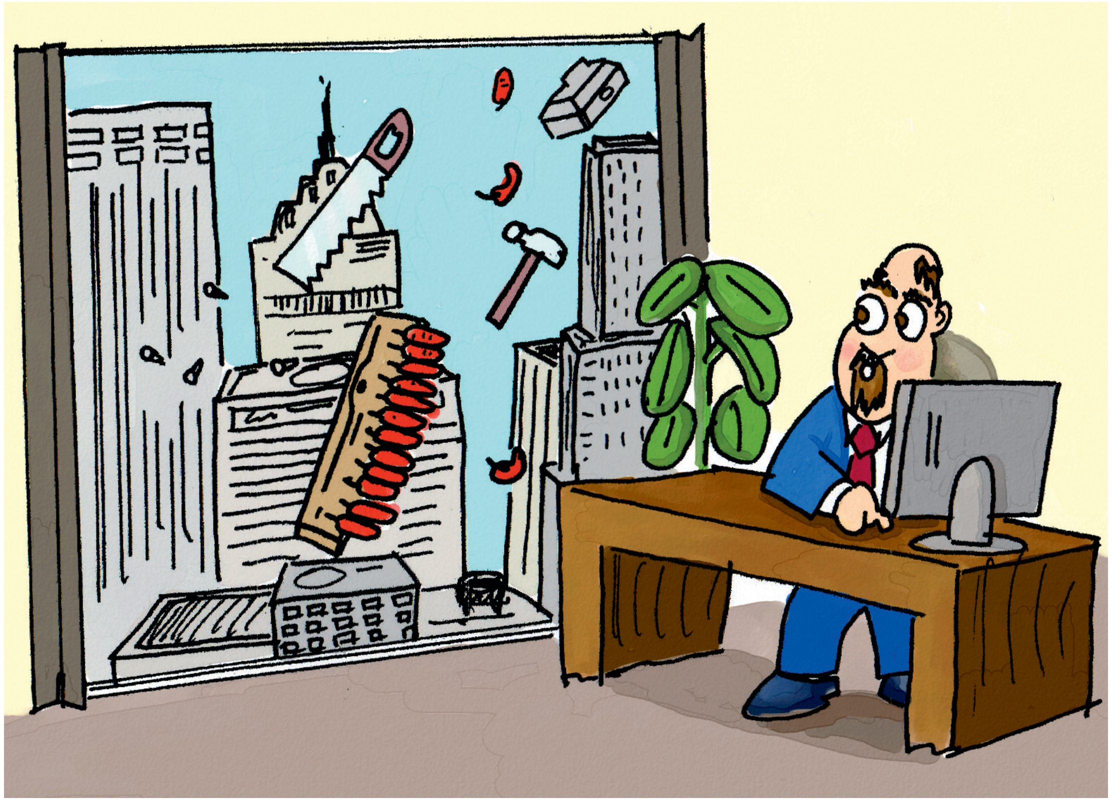
Aaron Brown

Building Your Wings on the Way Down

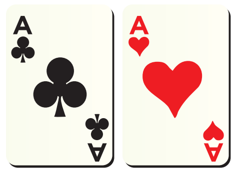
And while you're at it, learn to play poker too



Ray Bradbury famously defined "living at risk" as jumping off a cliff and building your wings on the way down. Too many financial risk managers who came late to the field think of risk as a passive bad thing to be minimized, an unfortunate by-product of profit-making activities, like air pollution, neckties or meetings. Ray understood that risk can be chosen and managed actively. Sometimes the value of being the first one off the cliff outweighs the risk of not getting your wings finished on time (and, in this case, not in time means not at all).

It would be foolish to jump off the cliff without being prepared to make wings. Obvious as that is, another common mistake is to choose a risk without also selecting a management strategy that gives it a chance of success. Some people have the wisdom to see this without bitter experience, the self-knowledge to pick strategies within their capacities and the discipline to adhere to plan. Or maybe not. I've never met one. I do meet a lot of people who never choose risk, a lot who choose risk without a strategy and a lot who apply a fixed strategy to all types of risks. The few who either select risks appropriate to their preferred strategy, or who have mastered a range of strategies so they have the right approach for any risk they happen to select, learned how to manage risk the hard way.

At the risk of oversimplification, there are four main types of risk, with four corresponding strategies. I first learned about them in poker, which if you play it seriously, forces you to learn risk management. But the same categories apply to investing and life.



Blue chip on your shoulder

The easiest risk to manage is the blue chip type. You pay top dollar for the best quality. A poker example is to start a hand of Texas hold'em with a pair of Aces. This is the strongest hand and is virtually always played. It's also pretty simple to play most of the time. Everyone knows what these hands are. It plays well with any number of players in the pot, so you don't have to try to manage that. You will usually stay in until you win or lose in a showdown. Another nice feature is if you do lose, everyone will agree you were terribly unlucky, no one will make fun of you for playing the hand. People are more likely to criticize the person who won for his impudence in betting with his lesser cards.

The stock market equivalent is to buy the least favored stocks, the ones no one else wants. Bad assets, bad earnings, bad prospects and bad management, but lots of problems

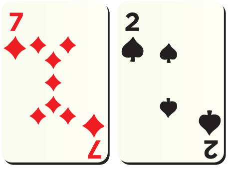
In investing, you buy stocks in the best companies. Like pocket Aces, everyone knows what they are. You buy and hold them, your risk reduction strategy is time. The market may go up and down and individual companies will have good and bad news, but over the long-term, a portfolio of the best companies should do well. And if it doesn't, everyone will commiserate you on your bad luck and you'll go to the poorhouse with the best companions.

Of course, everyone likes these companies, so you pay a premium over the assets and earnings. You justify this with the argument that you're not just buying the company today. The best companies attract the best people as employees, shareholders, directors and associates. This creates a positive feedback loop of success. In disasters, people will make sacrifices and work for the good of the firm rather than disappearing or rushing to be first to cut a deal with prosecutors. In good times, people will share the wealth in order to preserve the value of their positions.

I've got a blue chip streak in me. I chose to go to Harvard and the University of Chicago, I've worked for the biggest bank and biggest insurance company in the world, and I currently work for Morgan Stanley. I bought a large apartment in a top residential neighborhood of New York City, and built a lake house in a private conservatory with strict development rules and communal ownership of over 1,000 surrounding acres for protection. All those things were expensive, in money or occasionally other terms, but all of them have lasting value that a lot of rich and powerful people have interests in protecting.

But blue chip can be boring, and you end up hanging around with insufferable pure blue chip people. Even worse are people who miss the point, who always make the most expensive choice without investigating blue chip qualifications carefully. In 1999, the two stocks held by the most institutions were WorldCom and Enron, both valued at blue chip multiples, despite missing essential blue chip features. The world is full of high priced goods and services that lack the corresponding quality. Another problem is to make blue chip investments, but to trade them frequently. To a trader, a blue chip stock is risky. Its high valuation ratios can deflate quickly. Small irritations, quality lapses or scandals make a lot of difference to people paying top dollar for real estate, degrees or anything else.

Therefore I've made a few contrarian choices as well.



Mary, Mary, quite contrary

The worst starting hand in hold'em is 72 offsuit if there are at least four other players (and it's very near the worst for any number). Why would any one play it? As Christopher McQuarrie wrote in *The Usual Suspects*, "...[T]o be in power, you didn't need guns or money or even numbers. You just needed the will to do what the other guy wouldn't." In poker, you don't need Aces or suited cards or even connectors. You just need the guts to play the hands the other guy won't. The nice things about this hand are that it improves when all the Ace and King hands don't and that it's so unexpected, it can pay off big on the rare occasion that it wins.

The stock market equivalent is to buy the least favored stocks, the ones no one else wants. Bad assets, bad earnings, bad prospects and bad management, but lots of problems. In other markets you can snap up junior subordinated debt of issuers in default, busted PAC's and out of the money options near expiration on low volatility underlyings.

A guy I worked for once told me, "if I can buy it without holding my nose, I don't want it" (and he wasn't talking about cheese). His great talent was being so personally unpleasant that he got more than his share in workout negotiations just so the others could get him out of the room. There was a lot of competition for that role, but he was really good.

The contrarian reasons that a blue chip is so good, it can only get worse, while a contrarian pick is so bad, it can only get better. Everyone else hates it, and that must be reflected in the price.

Being a contrarian is harder than being a blue chip investor. For one thing, if you lose you will get no sympathy. Even if you win, people will not be happy for you, they are more likely to be angry that lady luck favored an obvious fool. Also, they will start attributing to you the characteristics of your investments. It's insidiously easy to go with the crowd that's all telling each other how contrarian they are, the true contrarian has to be a loner, has to make investments that other people don't even consider contrarian.

On the other hand, there is an individualis-

Risk type	Strategy	If you win people will say you have	If you lose people will say you are	Patterns
Blue Chip	Buy and hold	Quality	Unlucky	Many slow big gains, some fast big losses
Contrarian	Buy and sell	Luck	Insane gains,	Many quick small many quick small losses
Growth	Cut your losses and let your profits run	Vision	Gullible	Some slow big gains, many quick small losses
Value	Buy low, sell high	Common sense	Stubborn	Many quick small gains, some slow big losses

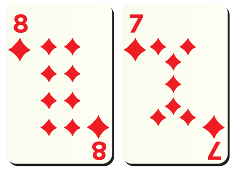
tic thrill to a successful contrarian play. When your blue chip goes up, you share your joy with smug millionaires. But when garbage turns to rubies, you have the exquisite rare pleasure of toasting yourself. You must feel this or you will not be happy in this role.

The surprising trap is to fall in love with garbage. You search for it eagerly, you buy it, but you won't win unless you sell it quickly. Contrarians, like everyone else, long to be smart, so they fall in love with their decisions. If the stock goes up, it was a success and must be held. If it goes down, it's even more undervalued and must be held.

No, it was garbage, and that's why you bought it. When it moves either direction, sell it. Your risk reduction technique is volatility. Even worthless assets move up and down, and if you buy them when they're down, they go up more often than down. But a tick up is not a sign that the nature of the asset has changed, while a tick down can be a warning of another unpleasant episode in the sorry history of this asset.

I've chosen some contrarian risks in my time. I played serious poker when it was neither admired nor considered daringly bad. I've hired people who had no other job offers after extensive searches, and I've worked for people no one else could stand. I played with toxic waste mortgage securities before David Askins made it first respectable, then scandalous. The first apartment I ever selected was a one room windowless basement in a bad part of Washington, DC (those are all positive attributes if you want to host a lot of high-stakes poker games). I bought a lot of junk bonds after Michael Milken went to jail. I've vacationed in some of the most physically unpleasant places on earth. I used to rent ski houses in the summer and unheated beach houses in the winter. I'm always tempted by the cheapest product. My first inclination in political opinions is to oppose as many people as possible.

But there's a nobler (I think) part of me that wants to build things greater than myself.



A plant of slow growth

Middle suited connectors in hold'em are two sequential cards of the same suit with the lower one 5, 6, 7 or 8. They are weak hands if they don't improve, but can become extremely strong hands with some luck. The more other players in the game the better this hand is, because it's likely to beat everyone or no one.

The trick to playing cards like this is to fold quickly when they don't improve, but to play them to the hilt when they do. Growth stocks have to be treated similarly. You find companies with small or negative earnings now, and weak balance sheets, but the potential for explosive returns with a little luck. You buy them and sell them soon if they don't go up. If they do go up, you have to hang on for the full ride to recoup your losses on other picks.

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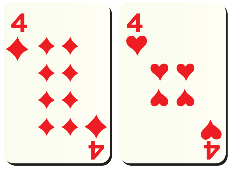
Buying growth stocks is easy, managing them afterwards is hard. Most people hate to take a loss. If this quarter disappointed, maybe next quarter will show a turnaround. If the thing you bought the stock for flopped, the same people have a lot of new ideas that might succeed. When you do hit a winner, it's tempting to take the quick profit.

Psychologically, it's hard to suffer many more losses than wins. While backing promising newcomers is fun, frequent disappointment takes its toll. On the other hand, your portfolio is disproportionately winners, since you sell the losers quick and hang on to the winners. Properly edited, your investment prowess will be the envy of cocktail parties because you can tout both your successes and your exciting current bets.

Growth investors reduce risk by diversification. The trick is to make lots of plays and not lose too much when one goes wrong. Sooner or later you'll get wins. The more you play, the safer the game.

I've tried some growth plays too. I had an apartment in Tribeca when there were no stores or certificates of occupancy. When I heard options were going to be big, I started trading options in 1980, then switched to mortgages in 1983 when people said that was even bigger than options. I quit my job as head of mortgage securities to go into risk management in 1988.When I heard everyone saying Internet stocks were overvalued, I started an Internet company in 1997. I've gone into business for myself two other times and made some plays to take over other businesses.

But for all these flirtations with blue chip, contrarian and growth, at heart I believe in value.



The price of everything and the value of nothing

In hold'em low pairs are the hardest hands to play. They're powerful hands if nobody improves, or if you improve the same amount as everyone. But they're easily beaten by the worst hands with even a small degree of luck.

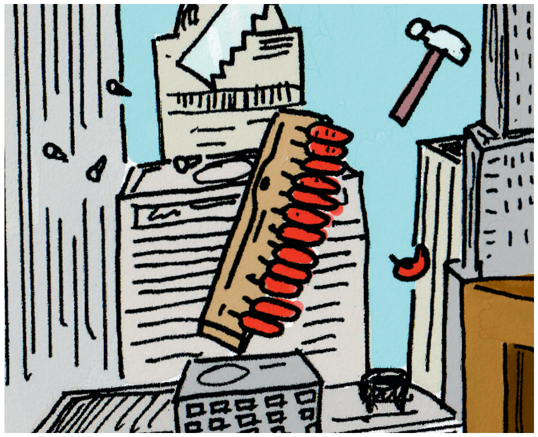
In investing, everyone wants to be a value investor like Warren Buffet, Benjamin Graham, John Templeton or Michael Price. You buy companies with high quality earnings, solid assets and sustainable competitive advantages, and you buy them when they are cheap. That's a hard combination to find, and often there are no suitable candidates in the market. You can find some blue chip companies in any market, there's always lots of garbage, and usually a lot of hope as well. But good value for your money comes and goes, and value investors must be willing to stay out of the market for extended periods.

Value investing also requires the most work. Everyone knows the blue chips. If you make a mistake analyzing a contrarian pick, the company is better than you thought. You can make money in a growth stock, even if it's flawed, as long as other people are willing to believe the story. That means if other people say it's a growth opportunity, it often is. But for value investing you need to look hard and make sure you see the value that everyone else misses, rather than missing the problems that everyone else sees.

Another problem is value investors don't make money from their initial purchases, they make money buying more when the stock goes down. You might ask, why make the first purchase then? The answer is you don't know when the stock will bottom, as a value investor you'd much rather get in too soon than too late. So you typically buy while the price is still going down, and buy more as it declines. That requires more discipline than most people have. When the stock does begin to rise, you must sell it as soon as it ceases to be good value for the money, that's also hard.

Your portfolio will be disproportionately losers, which can be depressing. But the hardest part of being a value investor is not going all the way down with a bad pick. I said before you have to buy more as the price goes down, but at some point you have admit a mistake. If you do it too soon, you will never be a value investor. If you do it too late, you will be a broke value investor.

In poker, the same rules apply. You will take some big losses playing small pairs, but if you do it right you will more than make it up by frequent smaller wins. You seldom win much, because your hand is very unlikely to improve enough to beat a good hand, a hand good enough to make a large bet. Even if that did happen, you normally play these hands to take a quick small profit rather than entice other players in for a potential larger payoff.



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You do have the advantage of winning more often than you lose, and never looking silly. You may lose money in the hand or the stock, but you will have something solid to justify your actions.

Value investors reduce risk by, well, value. In poker, your hand has strength, strength doesn't lose all the time. In stocks, your companies have earnings, assets and advantages. If your analysis was flawed you might have overpaid for them, but you're not likely to have worthless securities.

My biggest satisfactions in life are not from buying quality from others, or being right when everyone else is wrong, or backing good ideas. It's things of deep, lasting value, either creating them or finding them underappreciated. This is what I love, this is what inspires my faith. They are the most difficult things to have, but they are the best.

So step right up and take your chances. You can't tell the risks without a scorecard.