Confluence INVESTMENT MANAGEMENT

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Letter to Investors

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"What could go wrong?" When that question is uttered with confidence, wise folks immediately brace themselves for calamity. It is an oddity of the stock market that the more quickly a stock ascends in price, the less often people seem to worry about what could go wrong. Rising stock prices have a way of anesthetizing investors against concern that "something could go wrong."

There's nothing wrong with the question, but it matters whether it's voiced with hubris or humility. In our view, an investor needs to critically inquire as to what *can* go wrong before ever committing capital to an investment. This is where risk management starts. Most investors, however, tend to begin their work with the question, "How much money can I make?" But we have found that worrying about risk is even more important. That's because while the price of every security has an expected return built into the price (an earnings yield and rate of growth for a stock and a yield to maturity for a bond), the actual return depends on the probability that return is actually realized.

That probability is the answer to the question, "What can go wrong?" Good investors obsess over that question, whether the subject is an individual stock or the construction of an entire portfolio. We know that if we correctly understand the risks, we will better understand the probability that our return expectations will be realized. We can't predict the future (no one can), so it's a matter of doing our best to put the probabilities in our favor. That's where correct analysis of risk comes in.

Our analysts, strategists, and portfolio management teams spend more time on risk management than on any other pursuit. This activity doesn't guarantee against downside risk, of course. This is a "batting average" business, and the goal is not to eliminate risk, which is impossible, but to not knowingly accept unreasonable risk relative to the returns we expect. I have always thought that if we manage the downside appropriately, the upside will take care of itself.

Last quarter I referred to a book that over 40 years ago profoundly affected how I thought about investing: Benjamin Graham's *The Intelligent Investor*. In 2003, Jason Zweig issued an excellent revision and commentary on that classic which, if possible, made the original even better. In that edition is this insightful observation:

> *The longer a bull market lasts, the more severely investors will be afflicted with amnesia; after five years or so, many people no longer believe that bear markets are even possible. All those who forget are doomed to be reminded; and, in the stock market, recovered memories are always unpleasant.*

Even though the stock market has seen some sharp selloffs in the last five years, it seems to me we are living in such a time as Mr. Zweig describes. While the Fed has the overnight rate

at over 5% today, memories of extraordinary monetary support (0% interest rates for most of the last 16 years plus Quantitative Easing or bond-buying) have convinced investors that they won't be abandoned by the authorities. Then add a new productivity enhancer like Artificial Intelligence (AI) and the market had all it needed to take valuations to new highs. But there's no such thing as a risk-free market.

This is an environment where a long-term investor needs to consider the probabilities of *what can go wrong*. Is there a cost to weighing risk carefully? Of course, there is no free lunch. It means not chasing "hopes and dreams" stocks that others are, where the prospects of big gains are paired with big risks. The market today seems to be more excited about future gains than the possibility of loss. The wisest saying in the investment business is to "be cautious when others are bold and bold when others are cautious." We are a bit cautious these days but are prepared to be bold when the opportunities present themselves.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

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