



AlternativChronicle

The Complex Matter of Invisible Risk



By George M. Klar.....President, Alternativ Solution Inc.

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Alzheimer's Fundraising Results:



To my wonderful supporters.....who helped me raise \$6,065 to my Alzheimer's campaign. Our team raised a total of \$67,521 this season.

Since embarking on this mission seven years ago, I have personally raised over \$40,000, my team has raised \$500,000, and the Alzheimer's event has raised in excess of \$27 million.

Alzheimer's was virtually an unknown disease 20 years ago. Its devastating impact is well known today. Thanks for your continued and unwavering support.

Who we Drafted:

Our team drafted former Toronto Maple Leaf defence-man....**Al Iafrate**.

He was a great addition to our team and was fun to be with both on and off the ice.

....Cheers, GMK

Risk is one of those subjects that people discuss virtually any time. That's because risk is universally understood. From an early age, we are taught that risk is a bad thing. This implies managing risk is a key factor to success in work and life.

Whatever your day-to-day profession, I'll bet a large part of your job pertains to managing risk. Whether you're a physician, lawyer, chef, or sustainability expert, risk is the main ingredient that you must control.

Obviously, not all risks are manageable or predictable. Despite tremendous scientific advances, we cannot predict when natural disasters will occur or their severity. Whether the risk emanates from earthquakes (Nepal) or tsunamis (Japan) or tornados (USA mid-west), their outcomes are unknown. There are other naturally occurring risks such as disease (Ebola or Influenza). And of course,

there are certain risks that are man-made, such as overconfidence (Titanic).

In the field of finance, it's somewhat interesting to note that the concept of risk has become one-dimensional and largely mathematical. It is expressed in terms of volatility of an asset's price movements (or specifically, the standard deviation). The asset could be a publicly traded



security such as a stock, bond or commodity. But the asset could also be a private security (such as real estate, private equity or infrastructure).

Which brings me to today's

theme. In the past few years, a large number of institutional investors have deliberately shifted their portfolio's away from publicly traded securities towards alternative or private investments.

While there is absolutely nothing wrong with this decision (and in most circumstances it makes sense) one of the underlying rationales for moving towards these alternative private investments is to "lower risk".

However, a growing cadre of people are not convinced this rationale is 100% correct. Let me explain.

When an investor buys a publicly traded security, what exactly are they getting? For an equity investor, they become a passive part-owner in a business whose price is determined by the collective wisdom of the crowd, or marketplace. So the stock price fluctuates constantly. By this I mean the firm's (can't pg. 2)

Why I Fundraise for Alzheimer's?



By George M. Klar.....President, Alternativ Solution Inc.

Every year, I raise funds for Alzheimer's Research to help patients improve their quality of life. Also, I do it to help the next generation of elderly as Alzheimer's affects more people than ever (although, we are now seeing more Alzheimer's patients at far younger ages).

Every year, I received emails from my donors...one of which I'd like to share:

"One of my parents has Alzheimer's. I don't think you can really get a sense of how horrible the disease is unless you have a loved one who has it. I truly believe it is one of the worst ways to spend that last years of one's life and I hope a cure will be found soon."

Yes, we too hope a cure can be found soon!



perception is being assessed real-time by thousands (or millions) of people. The perception drives decision-makers to buy or sell the security. Consequently, in the public markets, the price of any stock (or security) will fluctuate second-by-second. Clearly, as new information or rumors emerge, perceptions change and hence the price.

The process described above is a simplification of what truly happens (I've excluded other possible contributors such as computer driven algorithmic trading or arbitrage). By virtue of the marketplace, we get something called **price discovery**.

But price discovery is a somewhat messy affair. We can never tell if the buyers or sellers are making decisions by rational or mathematical means, or whether they are driven by ephemeral factors, such as emotions. Indeed, a host of factors (such as strongly held beliefs) may also influence decisions.

However, it really doesn't matter how decisions are made since the results are identical. In public markets we get instantaneous price discovery along with considerable price fluctuations. Statistically, we use ever changing price quotes to determine the securities' risk. Mathematically, it is called volatility and it has become synonymous with "risk". Volatility appears in all public financial markets whether they be stocks, bonds, commodities, derivatives or foreign exchange.

Is there anything we can do to eliminate second-by-second price gyrations? Yes. One relatively simple way is to avoid assets that exhibit real-time price discovery. Pretty well any private (non-publicly traded) asset falls in such a category.

For these types of private assets, what type of prices are reported? Generally, they tend to be estimates produced periodically (such as quarterly or yearly) using valuation techniques that are often formula based. Infrequent valuations based on formulas dampen the calculated volatility. This produces a data stream that appears to be less volatile (and



Alternativ Solution Inc.

Toronto: 416-567-4464
george.klar@sympatico.ca

therefore more stable) than similar securities that trade on public markets.

What about the total risk the asset actually contains? Does this change if real-time price discovery is eliminated? Let's look at this question using a theoretical case study based on real estate.

Imagine two different sets of office buildings in the same city (Toronto, Calgary, etc.). Portfolio A contains 10 downtown office towers which are put into a



structure called a public REIT. This REIT trades on a stock exchange and has real-time price discovery.

Portfolio B, our second office portfolio, also contains 10 downtown buildings. More importantly, each building is adjacent to the buildings from Portfolio A (let's ignore cosmetic differences and assume each office tower in Portfolio A has an exact clone in Portfolio B). In such a circumstance, we can safely say that real estate in portfolio A and B are affected by the same macro or micro-economic forces. Lastly, Portfolio B is structured as a REIT, but this time a **private REIT**.

How are prices determined in the private REIT? Each quarter, an outside firm appraises the buildings (using accepted appraisal techniques) which are then reported to investors. Prices can and will change, but the magnitude of change tends to be less than with public market valuations. The valuation techniques

used actually focus on reducing price volatility.

What is very clear is that the risk in both portfolios is virtually identical as the assets are similar. But the volatility of the public market REIT will be greater than the volatility in the private REIT. So is the appraisal wrong? No. It is done using a different methodology versus how assets are valued on public markets.

Which volatility is correct — the public markets (by virtue of real time price discovery) or the appraiser's? This is where invisible risk comes in.

To answer this, let's put things in perspective. The private REIT structure was created because investors wanted a long-term investment and liquidity was deemed unimportant.

The public REIT was designed to give immediate liquidity even though the assets were always viewed as long-term. Thus, the desire for liquidity affected the reported volatility.

Does liquidity explain the risk differential? Yes. If both REITs were in the public market, both would exhibit identical volatility. The only reason the private REIT appears to be less risky is because of its structure. There is more risk than reported, but miraculously it remains invisible. This occurs in other alternative assets too.

An assets underlying risk doesn't change simply because of the financial structure some guru dreamed up. It's also wrong to view a private asset as being of lower risk because valuations are done infrequently. Some people believe these two portfolios have different levels of risk. In my view, this is a conceptual flaw. Nonetheless, could such a conceptual error be a driving force in moving funds away from public markets and towards private assets? I think yes!

Adding private assets to a public portfolio can make the portfolio appear to be less volatile, but this is just be financial sleight of hand. Invisible risk is real. Don't be fooled by those who say alternatives are "less risky". They just appear so based on the measurement system used. Remember, in finance (as in life), there is no such thing as a free lunch. ■