

# Return Per Unit of Stress

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An investor's job to intelligently bear risk for profit. Return alone – and especially return over short periods of time – says very little about the quality of investment decisions.

Investing is an adrenaline-laden world where too many people swing for the fences and hope that they connect. Operating a high-risk portfolio is like performing on the high wire without a net. The payoff for success may be high but those slip-ups will kill you.

*To finish first, you must first finish.*

– Rick Mears (4 time winner of the Indianapolis 500)

Return has to be evaluated relative to the amount of risk taken to achieve it. In other words, we must look at returns per unit of risk.

The concept of risk is abstract and does not mean the same thing to different people. To academicians who developed capital market theory, risk equals volatility/beta. I take great issue with this definition of risk but will save the discussion for another blog post.

Recently, I have started to incorporate another metric into my decision-making - 'return per unit of stress'. In other words, is the investment worth the headache? The higher the stress, the higher the profit has to be to justify it.

Fortunately unlike springboard diving, investors don't get extra points for difficulty.

| <b>High Stress</b>                      | <b>Low Stress</b>                       |
|---|---|
| Investing in highly leveraged companies | Investing in zero or low debt companies |
| Investing on margin                     | Not investing on margin                 |
| High frequency trading/day trading      | Long term investing                     |
| Shorting stocks                         | Long only investing                     |
| Corporate governance issues             | No corporate governance issues          |
| Cyclicals                               | Stable businesses                       |
| Activist investing                      | Passive investing                       |
| Futures and options trading             | Equities                                |
| Trading on inside information           | Avoiding inside information             |
| Event driven investing                  | Moats driven investing                  |