CAPCO
ASSET MANAGEMENT

The following is an excerpt from our third quarter 2008 letter:

On Avoiding Risk

In the past, we've written about the causes of this crisis, that "there must be a reckoning," and that we believed there was "much more to come." That reckoning has arrived with a vengeance, and we are as awed by its magnitude as you.

The devastating direct consequences are receiving ample coverage, and we won't rehash them here. But there is an indirect consequence that we think is worthy of comment: the increasingly frantic search by investors for something safe, and the growing fear that perhaps nothing is. The fact is that no investment is completely safe. The investing process, when done right, is about accepting that truth, and focusing on margins of safety against those risks. We speak of margins of safety precisely because we recognize significant risks.

In recent years, financial markets have cultivated an illusion that risk could be avoided, transferred, hedged, indexed, securitized, tranched, diversified, rated, insured, guaranteed, swapped and financially engineered into oblivion. Enormous time and money have been expended on these efforts, while little was expended on evaluating the actual underlying risks. Somehow, a collective belief arose that the risk was always somewhere else, and after a long period of stability and prosperity, this belief became deeply engrained. History buffs may appreciate that a similar faith in risk transfer helped bring on (and exacerbate) the 1987 stock market crash under the now-abandoned name "portfolio insurance."

We believe that all this risk avoidance activity actually increases the total risk in the system. First, many of the risk avoidance strategies carried their own (badly under-estimated) risks. Second, the fact that so many are all engaged in the same risk avoidance strategies leads to a panic when everyone loses confidence simultaneously. Third, the belief that risks can be offloaded tends to produce more risk-taking behavior, and investors indirectly took on far more risk than they might have directly. Lending one's own $300,000 to a borrower with a checkered credit history, against a $250,000 house in an undeveloped neighborhood, is a very different proposition than buying a "AAA rated tranche of a diversified pool of subprime mortgage backed securities underwritten by [the Wall Street institution of your choice]." Had investors had to make such loans themselves, with no ability to believe they had shifted the risk, fewer of these loans would exist today.

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As investors, none of us are entitled to a risk-free return, however much we might want it – even cash and treasuries are badly exposed to inflation. Investing is first and foremost about identifying and accepting risks and demanding a fair return for bearing them. The time others might spend trying to shift a risk is time we spend understanding it. Investors who deceive themselves into believing that they aren't taking risk may be taking the greatest risk of all.

This is exactly what recently befell so many large, well-regarded and purportedly sophisticated financial institutions. They engaged in financially reckless behavior, precisely because each convinced itself that it had offloaded its risk onto the others, when all they had done was pass it around to each other. Their proud names and long histories were no protection against the ravages of loose underwriting and heavy reliance on short term financing. And the fact that some have collapsed and some have survived is not necessarily the final separation of the wheat from the chaff.