Olstein
The Olstein Funds

OLSTEIN ALERTS

CONTROLLING VOLATILITY – A HIGH WIRE ACT WITHOUT A NET

"… the bona fide investor does not lose money merely because the market price of his holdings declines, and the fact that a decline may occur does not mean that he is running a true risk of loss… we apply the concept of risk solely to a loss which is either realized through actual sale, or is caused by a significant deterioration in the company's position–or, more frequently perhaps, is the result of the payment of an excessive price in relation to the intrinsic worth of the security."

Benjamin Graham, *The Intelligent Investor*

The definition of risk has become increasingly blurred, with many investors using the word volatility as a substitute for the word "risk" (especially when referring to short-term volatility). The permanent loss of capital is the greatest fear of a significant majority of equity investors. Many of the sophisticated strategies developed by Wall Street to control short-term volatility, in an attempt to allay investor's fear of risk, subject the investor to additional material risks that may be of a greater magnitude than the risks associated with the short-term volatility the investor is seeking to avoid.

Myth's Surrounding the Terms "Risk and Volatility"

Before investing in equity securities or determining the level of commitment to equities in a broader portfolio of investments, an investor must first assess his level of risk tolerance - that is, the ability to absorb a permanent loss of capital. To paraphrase value-investing legend Benjamin Graham, "the fact that a decline in the price of a security may occur does not mean the investor is running a true risk of loss." As Graham points out, the concept of risk should apply only to a loss which is realized through an actual sale of a security or a permanent loss of capital due to a significant deterioration in a company's financial position. Graham also points out that a permanent impairment of capital may, more frequently, be due to an investor paying substantially more for a security than its intrinsic worth. Since every equity investment may not perform as expected, an investor must consider whether his financial and psychological condition allow him to ride out a market downturn or the falling price of an equity security without engaging in panic selling.

AS A RESULT OF THIS EMPHASIS ON AVOIDING SHORT-TERM VOLATILITY, INVESTORS HAVE BECOME MORE FOCUSED ON SHORT-TERM PRICE MOVEMENTS.

Complicating an investor's ability to determine his true level of risk tolerance is the widespread emphasis that many institutional investors, hedge

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funds (the so-called "smart money crowd"), financial advisors, and the media place on avoiding volatility – that is, the short-term up and down movements in the price of a security which is often equated with risk. As a result of this emphasis on avoiding short-term volatility, investors have become more focused on short-term price movements. Risk management has become an exercise in reducing the impact of short-term movements (especially downward price movements) on a portfolio's current value.

The proliferation of risk management techniques has resulted in multiple methodologies, quantitative solutions, and analytical formulas for mitigating what is, in effect a narrow, short-term view of risk. While the possibility of a real loss of capital is, and should be, a major concern to all investors, many of the complex strategies developed to control volatility subject investors to undisclosed additional risks which could result in a permanent loss of capital and in fact, the undisclosed risks may be even greater than the risk associated with the short-term price movements they are designed to protect against.

The proliferation of risk management strategies is most prevalent in today's hedge fund universe including: long-short market neutral strategies which attempt to neutralize market exposure through the use of leverage (e.g. 150% long, 75% short) without sacrificing above average market returns; and capital-protected strategies that lower risk to an investor by giving up returns to pay for principal protection (employing options strategies, stop-loss arrangements, and derivations of portfolio insurance techniques, just to name a few). Yet each of these approaches, while attempting to manage risk and/or enhance returns can expose an investor to additional risks that in some instances are substantial, if not catastrophic.

Misperceptions and lack of investor knowledge surround most of the recently developed volatility reduction strategies – many investors, for instance, mistakenly believe that market neutral strategies offer the best of both worlds (long and short) because they offer the opportunity for double alpha or return and can serve as an attractive alternative to fixed income investments. What is usually ignored is the potential "double whammy" of risk uniquely associated with this approach – an unskilled investment manager may double the negative returns and permanently impair an investor's capital. Even a skilled investment manager running a market neutral fund must constantly determine whether his portfolio, due to the combination of securities it includes, is highly correlated to the market (not neutral at all). More importantly, a market neutral fund investor must also consider the risk that an unforeseen, low-probability event may have a disastrous effect on the portfolio, (the hedged positions act out of character) especially if the portfolio employs leverage to enhance returns.

PRODUCT STRUCTURES DESIGNED TO INCREASE EXPECTED RETURNS WHILE AT THE SAME TIME CONTROLLING VOLATILITY INTRODUCE NEW RISKS THROUGH THE USE OF LEVERAGE.

Product structures designed to increase expected returns while at the same time controlling volatility introduce new risks through the use of leverage. Leverage may be achieved through borrowing, deployment of proceeds from short sales, or, as in the case of most hedge funds, through the use of derivatives. Funds that employ substantial leverage are susceptible to material permanent loss of capital

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triggered by low probability unexpected economic or cataclysmic events which usually create market shock and could result in leveraged hedged positions moving in unpredicted directions relative to each other.

Recent disasters exacerbated by excessive leverage include, Long Term Capital in 1998, which lost over $4.6 billion in investors' capital despite having Nobel Prize economists on their staff, or the collapse of Amaranth Advisors in 2006 due to an incorrect, highly leveraged bet on the energy sector that resulted in a $6 billion loss in a matter of days. Thus, it is our conclusion that investors in funds that employ capital-protected strategies through the use of leverage not only surrender a material percentage of positive returns (to pay for the leveraged strategies designed to limit downside volatility) but are also exposed to material (albeit low probability) risks inherent in these arrangements.

REST ASSURED THAT ANYONE WHO BOUGHT PORTFOLIO INSURANCE IN THE 1980'S DID NOT FIND THEIR EXPERIENCE WITH THESE "RISK MANAGEMENT-DRIVEN" PRODUCTS VERY FUNNY.

The Wall Street marketing machine has developed many strategies to mitigate short-term volatility that, in our opinion, resemble the contraptions developed in the pursuit of human flight before the Wright Brothers took off from the beaches of Kitty Hawk. No matter how ingenious or well engineered these ill-conceived man made aerial devices were, not one achieved the dream of human flight. While the short films capturing these attempts at flight are often comical, rest assured that anyone who bought portfolio insurance in the 1980's (which failed miserably during the 1987 stock market crash because the product never anticipated a one day 500 point decline in the stock market) or invested in the supposedly low risk, high return strategy marketed by Long-Term Capital (which failed miserably in 1998 because their leveraged hedged spreads went into unchartered waters as a result of an unexpected international economic crisis in Asia and Russia) did not find their experience with these "risk management-driven" products very funny.

The preceding commentary represents the opinion of the Manager and is not intended to be a forecast of future events, a guarantee of future results or investment advice. This information should be preceded or accompanied by a current prospectus, which contains more complete information, including investment objectives, risks, charges and expenses of The Olstein Funds and should be read carefully before investing. A current prospectus may be obtained by calling (800) 799-2113 or by visiting the Fund's Website at www.olsteinfunds.com.

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