Beta Is Not Risk! What Should Investors Look Out For?

Description

I often see retail investors talking about beta in the context of how risky a stock is. These people often look for stocks with a lower beta because they think it implies less risk. However, that is not the case. The beta is simply a measure of how volatile a stock is compared to the broader market. If a stock has a beta greater than one, it means it tends to fluctuate more than the overall market. So what is a real measure of risk? In this article, I will discuss exactly that.

Good management?

If you cannot say yes to this first question, a red flag should be raised. Good management can be measured in many ways. It can also be fairly subjective. However, there may be instances that seem a little more obvious than others. Taking **Aurora Cannabis** (TSX:ACB)(NYSE:ACB) as a case study, I would say this is a good example of a company with poor management.

In early October, Aurora Cannabis was going through yet another rough patch in what has been a roller coaster ride during its time as a public company. Executives increased compensation. At the same time, the company needed to lay off more than 1,000 employees. This is a move that does not make sense, looking from the outside in. To make matters worse, Aurora Cannabis also reported $3.3 billion in losses that month.

A high degree of insider ownership?

This is a trait I look for in all the companies I invest in. Typically, I look for companies that are founder-led, and prefer those where the CEO has at least a 5% ownership stake in the company. Companies that feature a high amount of insider ownership indicate that its leadership team's goals are aligned with those of the shareholders.

Looking back at Aurora Cannabis, the company has a very low amount of insider ownership. Currently, company insiders hold a total stake of 0.4% in the company. The company's CEO, Miguel Martin, only holds a 0.02% ownership stake. A low stake in the company gives management little incentive to consider the return shareholders may see.

A large and growing moat?

A moat can be described as a competitive advantage over its peers. This can be in the form of its business model, advanced tech, or otherwise. Often, when a company has a large moat, consumers will turn to that company instead of its competitors. Looking at Q2 revenue for all public cannabis companies, Aurora Cannabis appears to not have a moat.

It reported the second highest quarterly revenue in Canada (numbers updated through October 29). Although it only trailed **Canopy Growth** in terms of revenue, Aurora Cannabis reported a quarter over quarter decrease in revenue of 5%. Year over year, the company reported a decrease of 27%. Compare those numbers to Canopy Growth which reported quarter over quarter and year over year growth rates of 2% and 22%, respectively.

Does the company face any legal hurdles?

Finally, the legality of the company's business can influence its risk. Cannabis is legal in Canada and has been for years. However, that is currently not the case in the United States. Although several states have either legalized, decriminalized, or allowed restricted use (medicinal purposes) of cannabis, it still remains illegal at the federal level. There are signs that suggest federal decriminalization may occur in the future, but that remains to be seen.

Foolish takeaway

A company's beta is not a measure of its risk. Rather, risk can be determined by examining a company's management, insider ownership, moat, and legal issues. Aurora Cannabis is a great example of a risky stock. Although it has shown incredible market support as of late, I would still be wary about jumping in without considering the risks associated with the company.

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