

Volatility Is Not Risk

The two should not be confused.

Provided by Advanced Wealth Management, Inc.

What is risk? To the conservative investor, risk is a negative. To the opportunistic investor, risk is a factor to tolerate and accept.

Whatever the perception of risk, it should not be confused with volatility. That confusion occurs much too frequently.

Volatility can be considered a measurement of risk, but it is not risk itself. Many investors and academics measure investment risk in terms of beta; that is, in terms of an investment's ups and downs in relation to a market sector or the entirety of the market.

If you want to measure volatility from a very wide angle, you can examine standard deviation for the S&P 500. The total return of this broad benchmark averaged 10.1% during 1926-2015, and there was a standard deviation of 20.1 from that average total return during those 90 market years.¹

What does that mean? It means that if you add or subtract 20.1 from 10.1, you get the range of total return that could be expected from the S&P two-thirds of the time during the period from 1926-2015. That is quite a variance, indicating that investors should be ready for anything when investing in equities. During 1926-2015, there was a 67% chance that the S&P could return anywhere from a 30.2% yearly gain to a 10.1% yearly loss. (Again, this is total return with dividends included.)¹

Just recently, there were years in which the S&P's total return fell outside of that wide range. In 2013, the index's total return was +32.39%. In 2008, its total return was -37.00%.²

When statisticians measure the volatility of major indices like the S&P 500, Nasdaq Composite, or Dow Jones Industrial Average, they are measuring market risk. Trying to measure investment risk is another matter.

You can argue that investment risk is not measurable. How can investors measure the probability of a loss when they invest? Even after they sell an investment, can they go back and calculate what their risk was at the time they bought it? They only know if they made money or not. Profit or loss says nothing about risk exposure.

Most experienced investors do not fear volatility. Instead, they fear loss. They think of "risk" as their potential for unrecoverable loss.

In reality, most apparent “losses” may be recoverable given enough time. True unrecoverable losses occur in one of two ways. One, an investor sells the investment for less than what he or she paid for it. Two, some kind of irrevocable change happens, either to the investment itself or to the sector to which the investment belongs. For example, a company goes totally out of business and leaves investors with worthless securities. Or, an innovation transforms an industry so profoundly that it renders what was once a leading-edge company an afterthought.

Accepting risk means accepting the possibilities of equity investing. The range of possibilities for investment performance and market performance is vast. History has shown that to be true, history being all we have to look at. It fails to tell us anything about the negative (or positive) disruptions that could come out of nowhere to upend our assumptions. A “black swan” (terrorism, a virus, an environmental crisis, a quick evaporation of investor confidence) is always a possibility. Next year, the performance of this or that sector or the small caps or blue chips could be spectacular. It could also be dismal. It could certainly fall in between those extremes. There is no way to calculate it or estimate it in advance. For the equities investor, the future is always a flashing question mark, regardless of what history tells or pundits predict.

Diversification helps investors cope with volatility & risk. Spreading assets across various investment classes may reduce a portfolio’s concentration in a hot sector, but it also lessens the possibility of a portfolio being overweighted in a cold one.

Volatility is a statistical expression of market risk, constantly measured. Volatility, however, should not be confused with risk itself.

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Citations.

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