If You Think Low-Volatility Investments Mean Low Risk, Think Again

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The following is adapted from Navigate the Investment Jungle.

As James Mai, founder of Cornwall Capital, eloquently says, “One of the great misconceptions of the investing public is equating risk with volatility.”

It’s easy to assume that the most volatile investments are the riskiest and the least volatile are the safest. This may sometimes be the case, but not always.

Conflating risk and volatility is dangerous. Mistakenly assuming low-volatility stocks are low-risk could cause you to take on excessive risk. Then, if the market turns against you, you could suffer deep losses.

To invest safely, you must understand the risk you're assuming, but it's easy to be distracted by volatility. So let's take a look at the differences between risk and volatility.

What Is Risk?

Every investment comes with risk, and it's important that investors understand the risk they're taking on prior to entering into an agreement.

To understand the risk inherent in a particular type of investment, we need to assess two factors: (1) the amount of money an investor could lose and (2) the probability of that loss.

If the amount of money at stake is high, investors will usually only tolerate a very small probability of loss, whereas if the amount of money at stake is relatively low, investors may tolerate a higher probability of loss.

Each investor will have a different risk tolerance. To accurately assess your personal risk tolerance, it's important to quantify the risk.

Advisors tend to use a 10 percent drop in value as a benchmark of what could happen in lean times. That doesn't sound like a lot and most investors are pretty comfortable with the idea that, in the worst case, their portfolio could drop 10 percent.

Now, what happens when we quantify that risk by putting numbers to that 10 percent? Let's say that a client has $300,000 to invest. If they lose 10 percent of that money, they'll be down $30,000. Does that seem palatable? Probably not.

Before you even look at volatility, you need to determine what level of risk is acceptable to you—how much money you're willing to lose and what probability of loss you'll accept.

What Is Volatility?

In simple terms, volatility is the degree to which an investment fluctuates in value. Usually, this is calculated with reference to standard deviation, meaning how much a given investment departs from the average.

Volatility can be correlated with risk, which is what has led to the misconception that the two are equivalent. However, this is not always the case.

Let's look at an example. Stock in Company A rises 15 percent in April, another 5 percent in May, and a further 10 percent in June. In total, the stock has risen by 32.8 percent across the three months. Great, right? It's also risen at wildly differing rates across those three months, from 5 percent to 15 percent. The stock is highly volatile but has delivered excellent returns.

Let's look at what could happen if the stock began to decline. Imagine that Company A hits a speed bump in July. In August, the stock declines by 15 percent. The same happens in

September, and again in October. By the beginning of November, the stock has declined by 38.6 percent from its June high. That's a serious loss.

Across the three months of August to October, however, the stock has exhibited low volatility. It has declined by a steady 15 percent, not deviating at all from the mean, although it's unlikely that this lack of volatility will be much consolation to anyone invested in the stock!

Do investors really care about volatility? Not much, compared with how much they care about their returns or losses.

How to Control Your Risk

When people confuse volatility and risk, they may make unwise investments and suffer painful consequences.

But if selecting low-volatility stocks doesn't guarantee low risk, then what does? The key is calculating risk and selecting a range of investments that spread and minimize risk.

Traditional investment advice often recommends a portfolio consisting of roughly 50 percent stocks and 50 percent bonds. At first glance, this may look like a good ratio of potential risk to potential reward, but stocks are almost five times riskier than bonds. With 50 percent of a portfolio in stocks and 50 percent in bonds, 95 percent of total risk is concentrated in the stocks. In terms of dollar allocation, the portfolio looks balanced. In terms of risk, it certainly isn't.

To control your risk, you need to limit exposure to the United States stock market to no more than 30 percent of a portfolio.

In the big picture, volatility doesn't really matter. So stop paying attention to volatility, and start looking at real risk.

For more advice on risk and volatility, you can find [Navigate the Investment Jungle] on Amazon.

Douglas Stone is a wealth advisor with SeaCrest Wealth Management, who brings twenty-three years of experience to his work with affluent households. Douglas began questioning his industry's approach seven years into his career, and in 2009, he left the major wirehouse where he worked to become an independent advisor. For six years, he discussed his self-taught, holistic approach to wealth management on Real Money with Doug Stone, a radio program on KMED 1440 AM in Medford, Oregon. Today, Doug shares his knowledge and expertise through workshops, seminars, and speaking engagements.