

Does Volatility equal Risk?



"A lot of people approach risk as if it's the enemy when it's really fortune's accomplice" - Sting

When investors think of losing money, they're often thinking about volatility. According to modern portfolio theory, the volatility of an investment serves as a gauge of the investment's risk. From this perspective, investments whose prices fluctuate widely are more risky than assets whose prices experience less volatility. Without a doubt, short-term fluctuations in the market values of stocks or portfolios can test an investor's resolve and can become especially uncomfortable when prices fall steeply or remain down for a long time. Using a measure of an investment's price volatility, however, may not be the best way to measure risk.

For most investors risk might be better defined as the odds of not achieving a spending goal (retirement, education, or other spending need) or reaching a wealth target. For investors aiming to meet these goals, risk might also include not saving enough or not allowing enough time for an investment strategy to work to meet the desired goal.

For some investors, price volatility can actually be a key source of investment opportunity. Often short-term fluctuations in the price of a stock reflect swings in investor sentiment, not changes in the true value of the underlying business. These sentiment-driven price changes can create opportunities to purchase stocks at substantial discounts to their true worth.

Another way to use volatility to one's benefit is to rebalance portfolios back to targeted levels. In short, rebalancing simply takes money from an investment or asset class that performed more strongly during a period and reinvests it in another investment or asset class. Applying this discipline on a periodic basis helps to lessen portfolio volatility, improve returns and increase the odds of achieving a financial goal. (see our November 2004 Commentary for a further discussion of "Using Stock Market Volatility to Your Advantage")

"Always try to buy securities as you would groceries - when they're on sale." - John Deysher

Risk isn't just the probability of losing money or not meeting a goal. Risk might also include the following:

- Failing to develop a long-term investment plan.
- Building a portfolio without regard to diversification.
- Abandoning a strategy solely because of short-term price fluctuations or weak performance.
- Confusing short-term price volatility with a fundamental change in value.
- Selling solely because the investment has gone down or buying because its gone up.
- Engaging in market timing or short-term trading activities.

"Instead of reading the plethora of stories telling you where to invest your money for 2005, do yourself a favor, beat the rush and start investing now for 2010 and beyond!" - William Nygren, Oakmark Funds

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Tune out the Financial Media

"What have we learned from the making and breaking of the '90s bubble...Don't put too much stock in Wall Street Strategists...Don't put too much stock in the financial media...Don't pay attention to anyone giving advice for the short-term." - No-Load Fund Analyst

Financial advice is everywhere. Is all that advice any good? Does the financial media help you invest intelligently or emotionally? Certainly some of the advice is good, but much of the financial media operates with incentives which may not be in the best interests of investors. Like any business, their goal is to increase revenues and profit. They do so by running stories that will maximize their audience, and accordingly, their advertising revenues. The media know that information sources can affect your emotions. And the best way to obtain viewers and readers is to appeal to emotions like hope, greed and fear.

Interestingly, the SEC (Securities and Exchange Commission) and other regulators sanction firms that don't operate in their clients' best interests. But there is no one around to hold the financial media accountable for their actions when they steer investors into making poor decisions with their money. Some in the financial media have an acute understanding of how most investors think - that you need to know the future in order to invest successfully. Realizing this behavior, the stories are often full of forecasts offered up by willing sources on Wall Street.

Do you remember the news headlines from 1999 and 2000? Some might have read; "It's a New Economy", "The Internet is Exploding", "Don't worry about price, just buy great companies!", or "The Dow is going to 30,000." And then during the market bottom in early 2003, the media stories focused on "Global Terrorism - No one is Safe", "Shock and Awe in Iraq", "Corporate Scandals - Trust no One!", and "The Dow will plunge to 5,000." The more dire or euphoric the story, the more who will listen. These stories are always designed to grab readers' attention and very rarely meant to offer the type of advice that will provide a successful investment experience. We aren't likely to see headlines that proclaim "Buy and Hold" or "Best Bet - Do Nothing!"

The answer: To be a better investor you should avoid most mainstream financial media. Publications like "Money" and shows like "Squawk Box" or "Mad Money" should be enjoyed for what they are - entertainment, not a consistent source for actionable advice.

"In 1999, there were 57 funds in our real-estate category. Back then, everybody hated them. Today, there are 88 funds in our real estate category, and everyone loves them. Seems like a pretty good contrarian indicator to me." - Kunal Kapoor, Morningstar

William Shakespeare on Diversification

In the opening scene of *The Merchant of Venice*, a Shakespearean comedy from the late 1500s, a character named Antonio tells a few fellow tradesman that he's depressed, but he can't figure out why. One of his friends asks if Antonio's inventory is being transported by "bottom", a term for a ship, and if the risk of trouble at sea might be causing him to worry. Antonio's reply suggests that he was an early advocate of the benefits of diversification:



My ventures are not in one bottom, Nor to one place; nor is my whole estate Upon the fortune of this present year. Therefore my merchandise makes me not sad.