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Volatility: Your (Crazy) Best Friend

So much of traditional portfolio theory rests on the assumption that volatility is the best way of assessing risk. I disagree. Risk and volatility are not the same thing. Risk is more closely aligned with uncertainty, not volatility. I addressed how to manage risk in the last paper so this one will discuss volatility and how to turn volatility into a friend (albeit a nutty one) rather than an enemy.

First, definitions. What is volatility and how do we measure it? Volatility is a term used to describe the variability in an asset's price. In finance, volatility is most often measured using σ (standard deviation). In short, the more an investment or a portfolio varies in its pricing or value, the more volatile it is. Volatility can also be measured in β (beta), which is its price deviation relative to a comparable index, such as the S&P 500 for a large company stock. This comparison is important because comparing the volatility of a portfolio of ultra-safe, short term treasury bonds to that of a risky small-cap stock fund wouldn't be a fair comparison. Other metrics are also used to evaluate volatility, such as the Sharpe Ratio. However, it is important to note that these are all ways of measuring and evaluating volatility, or the variations in an asset's price, not the risk that it will collapse or that the investor will lose money over time. Risk and volatility are not the same thing.

There are times when risk and volatility intersect, however. In short time horizons, risk and volatility are closely linked and, for all practical purposes, volatility can be simply one type of risk. For example, if an investor is looking to sell an investment within the next few years, it is more likely that a volatile investment will offer the investor a negative return than a more stable one. This is just a function of probabilities – the wider the range of possible prices, the more likely that one might be unfavorable over a short time horizon.

Aside from understanding the difference between risk and volatility, the most important thing to remember about volatility is that it is always backward-looking. As the old saying goes, past performance is not indicative of future results. An investment that has been volatile in the past might be stable in the future and vice versa.

Taken further, any measurement of relative volatility, such as β or Sharpe Ratio, gives us even less accuracy about its future price movements since the underlying investment's volatility will change over time as well as the index it is being compared to. In other words, while standard deviation gives one

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moving target, β and Sharpe Ratio give two moving targets as both the investment and its comparable index may have changing volatility each year. So while many advisors and the investment industry, as a whole, hold these metrics as the gold-standard of portfolio risk evaluation, I find them of little use. If anything, they can lure investors into a false sense of security rather than help them properly evaluate their holdings.

Rather than fearing volatility, many investors can use it to their advantage. I present 4 strategies that use volatility to the advantage of the investor. Readers should note that all of these are strategies for long-term investing, not short-term trading. By long-term, I mean investment timelines of 10 years or more and with enough consistency in its execution that temporary market gyrations won't cause the investor to abandon the strategy. For most people, this means that it must be done under the guidance or direction of a qualified investment professional. Likewise, although there are investments that deal directly with issues of volatility, such as exchange-traded funds that track the VIX, for example, this paper will stick with the long-term strategies that are possible for average investors to understand and implement under the guidance of a competent advisor. These are only broad strokes. Individual investors should consult a trusted advisor before implementing any of these strategies for themselves.

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Dollar-Cost Averaging

Given the choice between two investments with the same expected return, one being more stable in its price and one being more volatile in its price, many investors would choose the more stable one. In many cases, they're right to do so. If an investor is allocating their portfolio today with a single dollar amount and holding for the long-term, I'm inclined to agree that this is probably a good idea. But when an investor is allocating a small amount today and committing to that same dollar amount invested at regular intervals, as one does with a new 401(k) plan, for example, the more volatile investment might be the wiser choice.

Dollar-cost averaging is a well-known strategy where an investor commits a specified dollar amount to purchase shares at regular intervals. The share price will likely bob around over that time, usually several years. But whenever the share price drops, the investor commits the same dollar amount to the purchase, acquiring more shares on that day. And whenever the share price rises, the same dollar amount is used to make the purchase but then fewer shares are purchased. The net result is

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that, over time, it's possible for the investor to have a lower average cost per share than the average price per share over that same time period. The difference between the two is potential profit, over and above the actual return of the investment.

Dollar-cost averaging requires a rather stable environment overall. If the investment quickly or consistently rises in value, then it would have been better to go all-in early. But those kinds of things are nearly impossible to predict. In the real-world, there is always uncertainty. And under uncertainty, it is better to not overcommit.

This strategy is ideal for savers – people who are committing smaller amounts of money over longer lengths of time. Participants in 401(k) and similar kinds of employer-sponsored retirement plans are often doing this without even thinking about it. It need not be exclusive either. For example, if an investor

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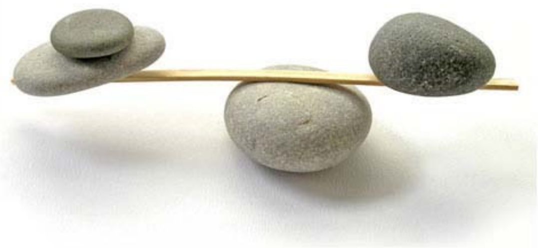
has built up a fair amount in their retirement accounts but is still saving and has no plans to retire in the next 10 years, then they may want to invest the bulk of their account in less volatile investments while also purchasing highly volatile investments with new money coming out of their paycheck. This is similar to the barbell idea presented in the last paper but with a new twist – hold safety with old money but buy volatility with new money.

This will, of course, require some attention. So it is not ideal for the set-it-and-forget-it investor. But for diligent investors or those working with professional advisors, the dollar-cost averaging strategy is a classic way to turn volatility into your friend.

Portfolio Rebalancing



One of the most common ways of managing an investment portfolio is to set an allocation of various investments, let's say 50% in stocks and 50% in bonds, for example. Usually, this is set at a level that matches the investor's tolerance for volatility and risk, as well as their objectives and time horizons.

But as the portfolio changes in value each day, those percentages change as well. Very quickly, the same investor may find that their portfolio is now comprised of 60% stocks and 40% bonds, due entirely to normal market fluctuations. Rebalancing the portfolio by selling some stocks and buying some bonds would allow the investor to return to their original 50/50 allocation. Doing this is considered prudent management because it keeps the investor within their stated risk tolerance and allows them to take advantage of price movements to lock in potential gains along the way.

But what is often ignored in discussions about rebalancing is that some measure of volatility is required for the strategy to work well. And in many cases, additional volatility can even improve returns over time. An invest-

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ment that is rather stable won't give many opportunities to buy and sell since, by definition, the price today is worth about the same as it was yesterday. But a volatile investment can give multiple opportunities to buy and sell as prices rise and fall. Given two investments, one stable and one volatile, that are likely to have the same long-term return, the more volatile one could be the best choice if an investor regularly rebalances their portfolio. Buying the dips and selling the peaks around a stable percentage can potentially add a nice boost to returns over time.

Rebalancing tends to work the best when the returns between the allocations are either non-correlated (not all rising and falling at the same time) or inversely correlated (rising and falling at opposite times). Especially in the latter case, higher amounts of volatility at the investment level can even increase the stability and resilience of the portfolio. This is a paradox but one worth noting – adding volatility may increase stability. This is partly why I don't buy into many of the portfolio metrics used by industry professionals – they often ignore correlation when looking at volatility. A volatile investment that is inversely correlated, such as one that increases in price when other assets in the portfolio decline in value, can help the portfolio to be more stable over time.

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Thinly-Traded Securities

Thinner trading volumes are usually synonymous with greater risk. Over the short term, this is definitely true since the price can vary widely on any given day (sometimes any given hour). A thin trading volume means that fewer shares, units, bonds, etc. are bought and sold. So motivated buyers may have to pay more and motivated sellers might get less if they are in a hurry to make the transaction.

Investments that trade frequently, with many buyers and sellers, also known as widely-traded investments, can usually be bought and sold with little to no impact on the price. But one that is thinly-traded may jump wildly when a single investor decides to buy or sell a large position. Therein lies both the possible danger and possible opportunity. Investors who hold thinly-traded securities can experience a wild ride of price movements. But they can also see abnormally good buying and selling opportunities that are nearly unseen with more traditional, widely-traded investments.
Holding thinly-traded securities is certainly not for the faint of heart. Prices can gyrate for all sorts of reasons and it is imperative to know when those price movements are due to the investment's fundamentals, such as earnings, debt, etc., or whether it's merely technical, such as a motivated seller. If an investor fails to keep up with these details, then these investments will likely disappoint. I certainly wouldn't advise anybody to allocate a large percentage of their net worth to thinly-traded securities – that's foolhardy.

But as a minority allocation, there can be some fun opportunities with investments that rarely trade. Over the years, I've seen very safe, insured bonds with interest that yields way above market rates simply because there are limited quantities available for sale. For a more patient investor, who can hold to

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maturity, another person's loss could be their own opportunity.

There's no free lunch in investing. But for those who can take reduced liquidity for a small part of their portfolio, there are sometimes great opportunities to find with thinly-traded securities.

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Conclusion

In summary, all three of these strategies use volatility to potentially benefit the investor. Volatility isn't always something to be shunned. It is like your crazy best friend – somebody who can be very helpful at certain times but who a certain amount of caution is always warranted lest they get you into trouble. While industry publications and articles can drone on about tempering volatility, lowering β and raising Sharpe ratios, I propose that investors use volatility to their advantage wherever possible and, of course, only whenever it's appropriate. Industry figures can be helpful to gain a sense of a portfolio's character in the past but they are not the end-all of prudent management nor do they accurately predict how a portfolio will behave in the future. Volatility can be a positive, even critical part of a portfolio's character.

Thankfully, an investor need not choose which one of these strategies they will implement. They are not mutually exclusive and can all run simultaneously and in varying amounts based on need or preference.

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