Volatility – Why be afraid of it

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Markets at times witness a lot of volatility. There are a number of reasons why:

- Technology, for one, has advanced enormously. At the push of button investors can now move money in and out of markets at any given time. These movements affect market values much faster than they used to in the past.
- Another reason is the actual volume of money that is moved in and out of markets. Currently we have a larger proportion of share market investors who want to maximise investment returns.
- Further, markets get impacted by different events occurring in other geographical or asset markets.
- A lot of people who participate in the markets have become short-termish and tend to book profits and losses at the earliest opportunity.

It's wise to note that not only the share markets experience volatility, in fact most investments do. That is why it's important to:
• Accept that volatility is a normal part of investing.
• Understand how best to benefit from volatility, rather than to be fearful of it.

Have you ever thought that stock market volatility can help you? Well, you may not think so, but it can really boost up your stocks! Many investors when they foray wonder what to do when the stock market falls. They sell or just sit on the fence and wait for the downward trend to cave in. The irony is that they actually begin to invest when the stock market is on the higher side.

It is quite strange as it goes against the normal approach. People tend to buy stuff when it is cheap while in stocks people purchase stocks when the market is on a higher side. Such a concept is known as the herd mentality, which indicates that since the market is ascending everybody is thinking that it will rise all the more and begin purchasing.

If you are an experienced investor, you will not be getting into such an odd thing, you will be applying something very different instead. You will be purchasing when the market is collapsing and that will be against the market, which is also called contrarian theory.

As you are constructing your portfolio for the long term you don't need to be bothered about the stock market falls. Every descending movement is a prospect for you to choose the stock. Rupee cost averaging is an alternate way to view it. You will choose some more of the stock every time the stock hits a low as overall price of holding will get minimized. This is the advantage of stock market instability, which is usually detested by many.

When markets are going down, and all you can see is the recent past, you have no way to tell when the decline will end, or if it will end at all. Human nature can be an investor's worst enemy, as it can incur doubt as to whether investment programs are sound. People tend to extrapolate current market trends and assume the worst.

We know that short-term market volatility is a reflection of the emotional state of the investors who participate in the markets, and in no way representative of the value of the businesses it represents.

The key aspect that you need to be careful about while employing the stock market volatility for your advantage is the fact that you need to do a decent research and analysis before venturing into a particular stock. You should pick a stock that you consider is good enough to be held for a minimum of three to five years and will earn you money after the decade.

Steps to minimise the effects of volatility

Diversify!
If your portfolio contains only one type of asset - for example, only shares - you will be fully exposed to the full impact of the rise and fall of the share market. By mixing your assets, i.e. adding property, cash or bonds/fixed interest to your share portfolio - you could be offsetting the poor performance of one asset, with the good performance of another.

Invest for the long term
In the big picture, volatility has little or no impact on long term investment returns. Volatility is a short term problem.

Invest in quality assets
Investments with reliable income streams and sound management are far less susceptible to volatility. When prices fall these types of assets usually tend to recover (and prosper) the fastest.

Stay the course , but rebalance
The most important thing investors can do is to stay the course. It is sensible to review your investment portfolios against your financial planning objectives: stay diversified and use the benefits of rebalancing.

A lot of investors dislike volatility. They reason that the up and down movement of the stock price makes it harder to predict. Higher uncertainty means higher risk, they say. Therefore, for the same reward, they prefer stocks that have lower volatility.

On the contrary, smart investors like Warren Buffett embraces volatility. He reasons that if a stock A is trading at Rs.50 and has a fair value of Rs.60. Shouldn't A be less risky if it plunges to say Rs.20 or Rs.15? That is a valid point. This of course assumes that the fundamental that caused the drop has not changed.

For entry and exit points, volatility increases our potential return. Another reason to like volatility is that it reduces uncertainty. Some of you might roll your eyes and think that this is nonsense. Let us explore this. What causes a stock to move? The stock price might move due to market sentiment. It also moves when it release earnings or new products or news about incoming threat from competitors. In other words, the stock price moves due to the news concerning the company. News are fact. Fact is certainty. Therefore, when the news is out, you get less uncertainty because the unknown has already been discovered. Be it bad or good, news always reduces uncertainty.

It is hard to fathom. But we need to embrace volatility. Sooner or later, a company will announce news, which can be good or bad. Either way, the stock price will be volatile when the news is announced. Volatility is bound to happen. Otherwise, how can investors profit from it? When a company's stock price does not move much, you can't profit much and vice versa. The trick is knowing when to buy and when to sell. That will determine your rate of return.

In times of tumult, it may seem odd to suggest that investors worry less. Human nature conditions us to fear uncertainty and dread failure. Falling prices are awful for shopkeepers who have to move merchandise and for the retiree who is selling assets to fund post-retirement living expenses. But, for net buyers who comprise the vast majority of us, falling prices, whether of merchandise or stocks, are wonderful. Yet how many of us feel this way? Most of us find it difficult to find joy in lower share prices, or, for that matter, to worry when prices are rising.

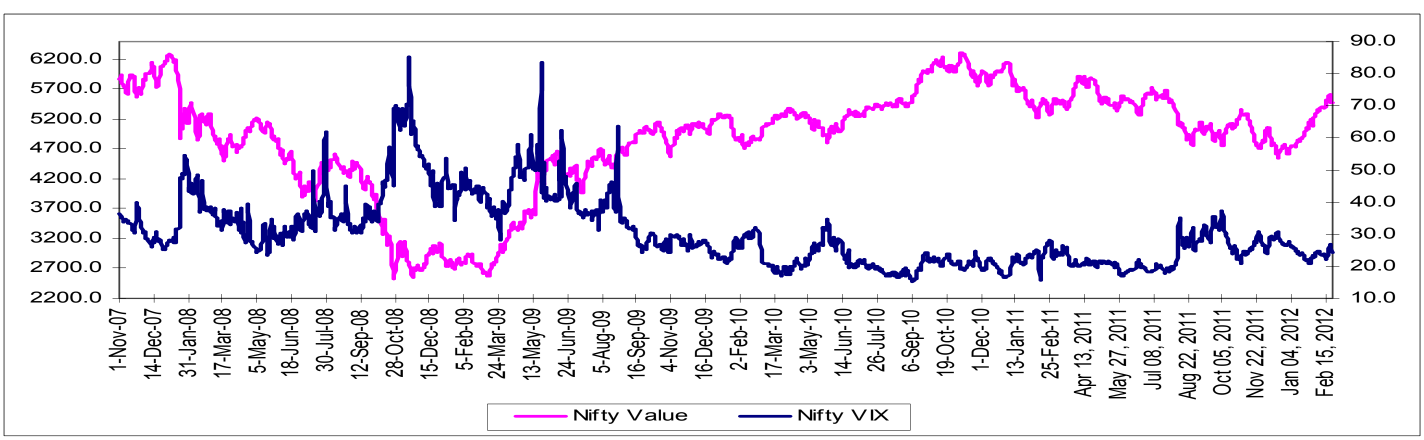
Studies conducted by researchers show that returns from equity markets are higher in periods that see a higher volatility. And we are not talking about volatility traders or short-term traders who love volatility.

It’s interesting to note that, for the true long-term investor, volatility is our friend. We can explicitly profit from it in two ways: we can shift our preferences from one investment to another, contra-trading against the fads, bubbles, crashes and shifting expectations of a fickle market. Because stocks aren’t the only asset available to us, we can buy them when they are cheap and, when they are expensive, we can turn our attention to bonds, or many other alternatives.

Also, the link between volatility and performance is far stronger than most people think (and stronger than theory suggests): selling in quiet markets and buying in the face of turbulence is profitable. The markets are supposed to pay a “risk premium”, to reward risk-bearing. The link is stronger, and more direct, than that. The stark gap between low returns, after periods of calm, and high returns after turbulence, takes most investors by surprise.

Why should there be such a powerful link between past volatility and subsequent returns? Simple. When markets are quiet, investors become complacent, and prices are likely to be higher than they would otherwise be. When markets are volatile, investors are fearful, and prices are likely to be depressed by that fear. Furthermore, when markets are quiescent, the next change is likely to be higher volatility, which breeds fear, taking prices lower. And when markets are turbulent, the next change is likely to be towards lower volatility. That eases the fear, boosting share prices.

The key issue to decide is whether markets have remained volatile for a reasonable period of time. If yes, it may be a good time to start buying stocks shortlisted after due analysis from a long term perspective.



From the chart above, it is clear that in the past (before Sept 2009) when the Nifty VIX spiked up to above 50, it would be a good time to closely watch and start accumulating stocks. The Nifty would have made a bottom soon thereafter. The Nifty VIX range has moved lower and later whenever Nifty VIX moved to 34 and above it was a good time to closely watch and start accumulating stocks. Similarly when the Nifty VIX fell to between 15 and 19, it would be a good time to review stocks from an exit perspective. Soon thereafter the Nifty makes a peak.

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