

With a combined 50+ years of experience, 2X Wealth Group is committed to educating and empowering investors. We firmly believe financial literacy helps people make better decisions.

Volatility ≠ Risk

Many investors don't understand the difference

Things that go up can come down and then go up again, and this month, the stock market is doing just that. Even the least nervous investor can get a bit queasy, but the stomach flipping is not likely to lead to long term illness. In this blog, we will try to clear up some common misconceptions about risk in financial markets and provide a way to think about the present bout of turbulence.



Volatility and Risk Explained

- **Volatility** is non-directional. Volatility measures how rapidly or significantly an investment tends to change in price over a given period of time, regardless of whether the direction is up or down.
- In contrast, **risk** is the likelihood that an investment will result in permanent or long-lasting loss of value.

An investment can be volatile - fluctuate wildly in price - even though its value may be stable or increasing over longer periods of time. However, there are situations where volatility presents a clear risk - the likelihood of permanent loss - to your investments.

- **Volatility presents a risk to portfolios when the investment timeframe is short.** Why? Because you may need to sell when the price happens to be down. With a longer timeframe, the risk of locking in a loss is reduced.
- **A burst of volatility can also signal increased risk if it's caused by a fundamental negative change affecting the long-term value of an investment.** An example would be the sea change occurring in China, where the communist party's long-term goals now affect the ability of companies to make a profit (See blog: [From Beijing to Wall Street](#)).

Equity Returns and the Importance of Timeframe

On any given day, the odds of the S&P 500 being higher are only slightly over 50/50 (52.43% to be exact). If you go out a month, the odds go to 60.07%, and over the course of a year they rise to 69.33%. However, for any **5-year period** over the last 100 years, the odds of a positive S&P 500 total return have been 89.1%. As shown in the charts below, **the risk of a negative outcome declines as the timeframe increases, demonstrating how a volatile asset like the S&P 500 can produce positive outcomes over time.**

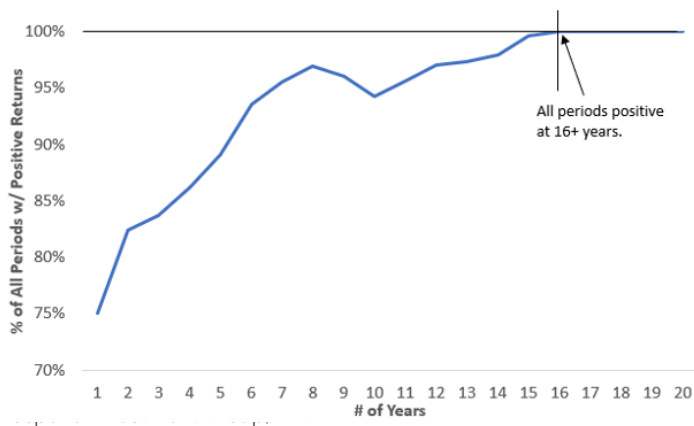
Positive Returns by Timeframe

S&P 500 Price		S&P 500 Total Return	
Time Frame	% Positive	Time Frame	% Positive
1 Day	52.43%	1 Month	62.78%
1 Week	56.17%	3 Months	68.24%
1 Month	60.07%	6 Months	71.11%
3 Months	63.64%	1 Year	75.09%
6 Months	66.69%	2 Years	82.45%
1 Year	69.33%	3 Years	83.73%
2 Years	76.01%	5 Years	89.10%
3 Years	77.91%	10 Years	94.22%
5 Years	79.30%	20 Years	100.00%
10 Years	88.42%	30 Years	100.00%
20 Years	96.30%		
30 Years	100.00%		

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The following historical chart shows that in any period longer than 16 years, the odds of a positive return were 100%.

S&P 500 Total Return: % of Time Positive by # of Years Invested



The Benefits of Volatility

- Price gyrations mean getting another chance to buy something that you thought was too expensive – particularly in a market like the current one with its rolling stock and sector corrections.

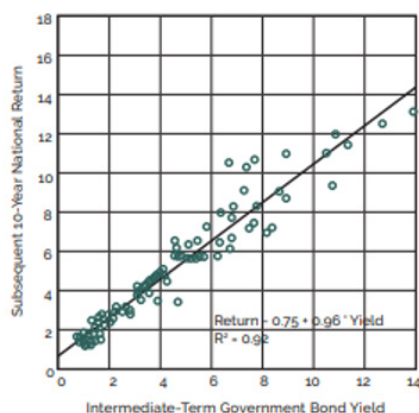
- In taxable accounts, price volatility provides an opportunity for tax loss harvesting – a technique used to book losses for tax purposes. Selling one security at a loss and subsequently reinvesting the sale proceeds in an alternative investment allows investors to maintain their market exposure while benefitting from the tax loss. For example, you could sell your Morgan Stanley position for a loss and reinvest in Goldman Sachs, thereby keeping your exposure to high quality investment banks the same.

The Risk for Your Financial Plan

Investors' misconceptions about risk and volatility can prevent them from meeting their financial goals.

Historically, investors who feared volatility often chose a 60% allocation to equities to achieve their financial goals. The classic 60% equity, 40% bond portfolio performed similarly to an 80% equity portfolio for decades, **with a lot less volatility**. Hence, it's popularity. The primary reason for this outcome was the 40-year bond bull market lasting from 1982 to today, where 10-year Treasury rates fell from about 16% to 1.3%. Further, the average bond yield over this period was about 5%. The combination of falling rates and ample bond yields provided plenty of opportunity for positive bond total returns.

Today, the situation is entirely different. We are starting with very low bond yields - which portend low total returns from bonds going forward. The 10-year bond yield today is a very good predictor of bond total returns **for the next 10 years** – i.e. predicting around 1.5% total returns! **The chart below, shows a very high 82% correlation between current yields and 10-year total returns.** As you can see, the correlations are especially strong when rates are lower (the lower left portion of the chart).



What To Do About Low Bond Returns

One option would be to increase equity allocations above 60% to help your portfolio grow in a low yielding environment. According to a Wisdom Tree Analysis published in August 2021, using a real (inflation adjusted) equity return of 4.5 to 5% and 0% real returns for bonds, a 75% percent allocation to equities accomplishes two objectives versus a 60/40 portfolio:

- It potentially minimizes the probability of outliving your money over a 30-year time horizon
- It potentially increases the ability to fund legacy objectives

If you can't stand the heat of higher equity allocations and want to get out of the kitchen you have a few choices...

- Save more
- Retire later
- Withdraw less in retirement

The Elephant in the Room - How do you Protect Against Inflation?

The danger of feeling safe in cash is that cash will buy you less and less over time due to inflation. In periods of moderate inflation, equities provide better inflation protection than bonds. As inflation goes higher, commodities can provide some additional protection. Please see our 1st Quarter 2021 Letter "Embracing a Changed World".

The Danger of Equating Volatility and Risk...

Equating volatility and risk leads investors to *overestimate* the risk of high equity exposure and *underestimate* the risk of low equity exposure, which is particularly dangerous in an inflationary environment with low bond yields.

Embrace the volatility and enjoy the ride. If the stock market isn't enough for you, there is always the Giant Dipper!

For more of our views, we suggest:

[Bitcoin Billionaire???](#)

[Robinhood, Reddit, GameStop and You – The Making of a Financial Flash Mob](#)

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