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Portfolio Strategy

Why volatility is not to be feared

In the second of a three part series, Didier Saint-Georges, managing director and member of the investment committee at Carmignac, takes a closer look at why volatility does not mean a red flag and the dangers of 'Turkey Syndrome'

Didier Saint-Georges

Financial markets often undergo rapid, erratic swings that are neither large in magnitude nor clear in direction.

Such volatility is the tangible expression of investor uncertainty at a given point in time, and can be measured, by calculating the magnitude of asset price fluctuations. So asset managers often use volatility as a proxy for risk. But that has caused confusion in the minds of many investors.

While it is true that volatility is a measure of uncertainty, investors often – and mistakenly – take it as a red flag. But in financial markets, just as in daily life, the fact that something moves quickly and in opposing directions does not necessarily mean it is fragile. That could even be a sign of flexibility and enhanced resistance to shocks.

Life is made up of movement – just ask Muhammad Ali, Blaise Pascal or any knee doctor.

Nassim Taleb, the essayist, scholar, statistician, former trader, and risk analyst, whose work focuses on problems of randomness, probability, and uncertainty, likes to point out that a taxi driver's income may be volatile, but at least it will not disappear overnight because he has been fired.

By the same token, a financial asset, market or fund that exhibits some volatility could turn out to be extremely robust.

On the other hand, a highly stable financial asset could suddenly implode or lose its value little by little, without volatility but with a sure and steady decline in a couple's retirement savings, for example.

Bund lesson

Take the example of a cautious investor who prudently invests his savings in German government bonds. Presuming a slow but inexorable rise in German interest rates, the value of his investment – which already offers a meagre return – would shrink with each passing day, since a bond that pays a low coupon is worth less when interest rates rise as investors can invest in new bonds offering higher coupons.

Achieving attractive medium-term returns necessitates putting up with short-term noise. You cannot expect to make handsome gains in the long term if you aren't willing to ride out some turbulence in the near term

Our cautious investor would see his savings slowly evaporate – without volatility.

The value of his 'safe', stable investment could even take a nosedive if interest rates were to shoot up. That is what happened in Germany in the spring of 2015; many European investors had bought the country's bonds because they were seeking a safe-haven asset. The yield on these bonds was nearly zero, but that was the 'price' investors were willing to pay for the security of this top-tier paper.

But in early April 2015, a brighter outlook for Europe's economy sent eurozone interest rates spiralling upwards. German bond prices fell accordingly, shedding 9% between 20 April and 10 June.

So what had been considered one of the world's most stable investments suddenly proved to be much riskier than previously thought.

'Turkey Syndrome'

Investors in German bonds fell victim to the "Turkey Syndrome": a turkey fed regularly throughout the year comes to view the world as a stable, calm, predictable place – until the day before Christmas, when it suddenly becomes aware that this stability was highly misleading.

Granted, volatility in itself is not something to wish for. And fund managers should not use "volatility" as a euphemism for highly erratic returns due to poor investment decisions or excessive risk-taking. But neither is volatility something to be feared.

On the contrary, achieving attractive medium-term returns necessitates putting up with short-term noise.

You cannot expect to make handsome gains in the long term if you aren't willing to ride out some turbulence in the near term.

The first red flag that should have tipped off investors in Bernie Madoff's funds was their extremely low volatility.

His clients thought they had stumbled across a crackerjack fund manager, but in fact they were just the latest victims of the Turkey Syndrome.

Aiming to stamp out volatility, which is nothing more than a swing between tiny losses and tiny gains, is hardly a good basis for investment decisions.

TOTAL RETURNS (MONTH END as of 12/31/2015)	Fund %	Index %	IA sector avg %
1 Month	0.64	0.52	-0.44
Year to Date	15.95	7.26	4.46
1 Year	15.95	7.26	4.46
3 Years Annualised	-	-	-
5 Years Annualised	-	-	-
10 Years Annualised	-	-	-
Since inception (annualized if >1y)	16.87	13.90	11.87

Past performance is no guarantee of future results.

Top 10 Holdings Fund – U.S. Equity Leaders	**%**
Amazon.Com Inc.	6.9
Facebook Inc-A	5.8
Visa Inc-Class A Shares	5.3
Cisco Systems	5.2
Oracle Corp	4.7
Monster Beverage	4.3
Alibaba Group Hldg Adr	4.0
Qualcomm Inc	3.8
Coca Cola (The)	3.7
Procter & Gamble Co/The	3.4

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