

Beware Low Volatility

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Market volatility has fallen to very low levels over the past few years and this creates a conundrum for investors. Low volatility levels indicate that you can take on more risky exposure (to generate higher returns) for your risk budget. With volatility so low, should they embrace higher exposure to risk assets or, as we would highlight, is this a mirage that could actually lead to capital losses in the future in certain assets if not managed properly.

Investors have long exhibited a bias towards gains and an aversion to losses since the beginning of time. It is important to remember however that certainty is never 'free'. Even those seeking certainty through seemingly free short term cash investments, pay heavily over longer term investment horizons as cash underperforms growth assets and may not keep pace with inflation. Whenever it appears certainty can be increased without cost, you are paying something – normally through the future returns you generate.

Our focus on permanent impairment of capital leads us to embrace volatility rather than worry about it. Market fluctuations are inevitable. Without volatility, gains cannot be realised whilst new opportunities are opened up by market volatility. Instead of looking at falling share prices as something negative, investors should view it as an opportunity to acquire ownership in fundamentally strong companies at low prices. The valuation you buy an investment at today matters for the return you generate in the future. Likewise, rising markets should be looked at in the context of longer term expectations.

Unlike the market value of a business, a company's real intrinsic value does not dramatically fluctuate on a day-to-day basis. This means that the price at which a share in a company trades at on the market may not accurately reflect what that piece of ownership is actually worth. On many occasions the fluctuations in the price of an investment are influenced by external factors that have very little to do with the actual fundamentals of that investment. These factors include a change in expectations in the economy, change in monetary or fiscal policy, a natural disaster and even the implementation of new laws and policies by the government. It is these factors that increase volatility and in turn allow us to purchase investments at lower valuations and we should be willing to sell them at higher ones.

At present, rising markets have created a sense of complacency which needs to be monitored carefully. When the dynamic of ever lower volatility in equity markets will alter we cannot be sure, we can however be certain that it will. When it does, those areas trading on rich valuations will suffer the most and it is likely investors will suffer outsized capital losses as they allowed low volatility measures to lure them into actually taking more risk than they thought.

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