ADVISOR PERSPECTIVES

The True Cost of Volatility

By Dan Richards*

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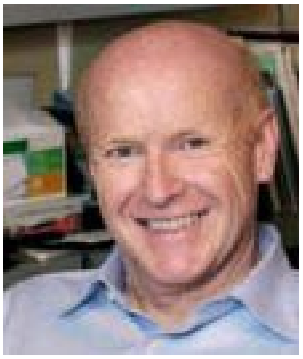

Most advisors and investors hate volatility – the up and down hits to clients' long term goals. (To be more accurate, we hate the downs – the ups we don't mind so much.)

And clients pay a big price for that volatility – not just stress and lost sleep at night, but volatility in portfolios that induces behavior that costs many investors serious money.

Lots has been written about the twin emotions of fear and greed that cause investors to buy at the top (when greed prevails) and sell at the bottom (when fear takes over) – quite simply, most investors don't have the stomach to ride market ups and downs with equanimity.

That's one reason investors benefit from working with a financial advisor. Good advisors serve as an emotional anchor, keeping the highs from being too high and the lows from being too low.

But good advice isn't enough; clients also need portfolios they can live with.

At a recent conference, Don Phillips of Morningstar presented an analysis of how U.S. mutual fund investors did in the ten years to the end of 2007, comparing this to the performance of the funds in which they invested. In calculating the investor return, Morningstar factored in when investors bought and sold and the returns during the periods they held funds.

For boring balanced funds, the annual investor return was 7.88%. Because of when they bought and sold, investors narrowly outperformed the return they would have received if they simply bought at the beginning of the ten years and held on – that strategy would have generated 7.80% per year.

Compare that to funds invested in narrower sectors such as tech, health care or energy. The average return on these funds was 9.53% – they did much better than the stodgy balanced funds.

And the investors in those sector funds? The investor return was 6.75% – investors did much better in balanced funds than in sector funds, not because the balanced funds performed better (they actually did much worse) but because most investors couldn't stomach the ride in sector funds. Obviously narrow sector funds can boost returns and fit the higher risk portion of a portfolio, but almost all investors need help from a financial advisor to have even a remote chance of getting the timing right.

	10 year investor return	**10 year fund return**
Equity sector funds (e.g. tech, health, energy)	6.75%	9.53%
Balanced funds	7.88%	7.80%

Morningstar took this one step further. For each asset class (for example value stock funds, bond funds, emerging market funds), they divided the participating funds into two categories – those whose volatility (as measured by standard deviation) was higher than average and those whose volatility was lower than average.

They looked at the performance of the high volatility and low volatility entries – and compared this to the investor experience.

The returns of high volatility and low volatility funds were almost identical – about 6.25%. The investors' returns in those funds were very different however. The actual investor return in the low volatility funds was just under 6%, almost matching the return on the funds themselves.

On the other hand, the investor return in the high volatility entries was 4.32% – over the ten-year period measured, higher volatility cost investors in those more volatile funds almost a third of their return.

	10-year investor return	**10-year fund return**
Lower volatility funds	5.97%	6.21%
Higher volatility funds	4.32%	6.28%

The reason that volatility extracts such a big price on investor return is quite simple – investors lose patience and fail to focus on their long-term objectives.

When Peter Lynch ran the Fidelity Magellan Fund from 1977 to 1990, he averaged a remarkable annual return of 29%, over twice the U.S. market average.

And how about the investors in his fund? They picked the right manager, as Peter Lynch more than did his job – but their return was in the single digits. This drastic underperformance was driven by counterproductive investor behavior- investors typically bought and sold at the wrong times, buying high right after periods of strong performance and then riding periods of weak performance or declines, at which point they sold low.

There are some important lessons here for investors, financial advisors and mutual fund companies.

First, fund companies who focus on narrow sector funds don't typically do investors any favors – it's clear that most investors are best served by broader based entries.

Second, it's not just returns that count; the volatility accompanying those returns is important. Performance has to come first – after all that's what managers are paid for – but even for offerings in higher volatility categories such as emerging markets, fund companies should strive to have their funds operate with as little volatility as possible.

Advisors need to be aware of the risk of putting their clients into volatile investments, such as narrow sector funds, even when clients ask for them. And if advisors have a choice between recommending two alternatives with similar performance histories, their clients will almost always be better off with the less volatile alternative.

Lastly, some lessons for investors.

In one of his annual letters to investors, Warren Buffett wrote that he'd prefer a lumpy 15% return to a smooth 12%.

That may work if you have his discipline. For clients who are mere mortals, advisors need to help them better understand their stomach for risk in volatile investments such as commodities and oil stocks. The next time a client approaches you about jumping into an investment that has done well over the past while but which has experienced big swings along the way, you need to have a frank conversation about whether they'll be able to hang on for the ride.

** Dan Richards conducts programs to help advisors gain and retain clients and is an award winning faculty member in the MBA program at the University of Toronto. To see more of his written and video commentaries and to reach him, go to www.strategicimperatives.ca.*

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