Stock Market Volatility: The Key to Maximum Returns.

"Look at market fluctuations (volatility) as your friend rather than your enemy; profit from folly rather than participate in it."
Warren Buffet

Volatility is an inherent phenomenon in financial markets across the globe. The impact of volatility depends on the investor's perception towards its (volatility) dynamics. An optimist would explore the limitless opportunities in a volatile market while a pessimist would tremble in the midst of volatility as they will be unable to grasp the art of maximizing opportunities in such markets. The article attempts to instill the correct attitude and skills required to be a front runner in volatile markets.

What is market volatility?

Volatility is the relative rate at which the price of a security moves up and down. Volatility is measured by calculating the annualized standard deviation of the daily change in price. The price of a stock is determined in free markets based on the demand and supply for stocks that is shaped by investor sentiments. Rational or not, investor sentiments will always be subjected to change. Hence in the short run, stock prices don't always climb in nice straight lines. A chart of day-to-day stock prices looks like a mountain range with plenty of peaks and valleys, formed by the daily highs and lows. However, over months and years the mountain range flattens into more of a gradual slope. The degree of volatility adjusts over time.

The United States of America (U.S.A) was the super power when it stepped in to recession. As a result the highly developed equity market stumbled. With the economy gradually reviving the market has outperformed many of its regional peers. In spite of the upward trend the market is currently responding to the uncertainty pertaining to the drop in oil prices. The market is expected to come back to normalcy when the heads of OPEC meet next week to finalize the matter.

The growth story of the Colombo Stock Exchange (CSE) is an ideal example to reaffirm the aforementioned. The All Share Price Index (ASPI) was ranked as the world's second best performing market with a growth of nearly 300% during the last 5 years. In spite of the extraordinary growth, the market was subjected to different levels of volatility in the short run during the last 5 years. It supported market correction, paved the way for attractive valuations and at times increased capital gains in a considerable manner. Unfortunately we accept upward price movements with open arms while the opposite is witnessed when prices are going down.

Do you have the right attitude towards volatile markets?

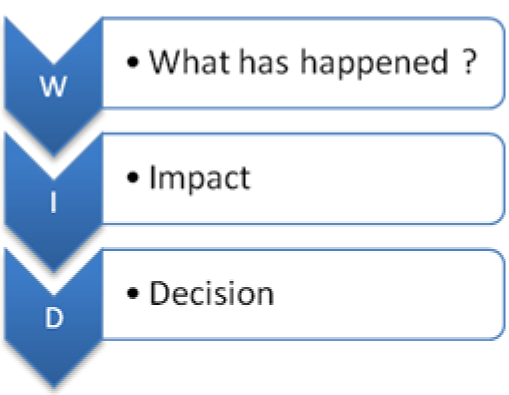
It is important to note that the stock market tends to decline swiftly during a downturn as fear triggers sell orders and out do the buy orders. While this is not always the case, it is a reasonable rule of thumb in most markets including Sri Lanka. The situation is intensified due to the 'herd mentality'. It is a mentality characterized by a lack of individual decision-making causing people to think and act in the same way as the majority would and thereby follow their investment decisions.

There are many factors that could attribute towards a downturn. It might range from company specific reasons to macroeconomic or even political reasons. We understand that it is not an easy task to watch your portfolio shrink when markets continue to respond to certain information. However the correct attitude towards such a situation requires endurance and above all independent, informed and rational decision making bearing in mind that the equity market is a long-term investment.

In general, markets are sensitive to information. Hence it is normal for the market to react to market sensitive information. Yet all market sensitive information will not hold a considerable impact on the market in the long run.

A simple key towards informed and rational decision making would be "WID''. The first step is to ask yourself what has happened. You should be vigilant when you grasp information given through local chat rooms, individuals, media etc. There will be varied interpretations towards certain incidents but never base your decisions on a hearsay basis. Infer if these reasons could actually have an impact on the market in the long run. This would be easier if you study the response of the market amidst similar situations using historical data. Historical data would reveal that the market would respond to information but later adjust based on intrinsic valuation. Accordingly take your decisions. The same applies when the market is shooting up. 'WID' will enable you to sit back and question the sudden surge in the market instead of randomly investing.

Figure 1 – WID: Decision making in volatile markets

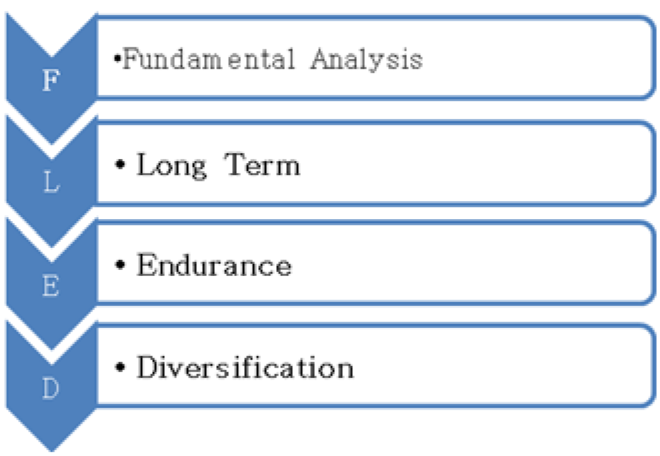


A pragmatic approach towards addressing a downturn market would be to rebalance the portfolio by purchasing shares at lower price levels. As correctly explained by the father of value investing (Benjamin Graham), the market will set a price and the intelligent investor will know the fundamental value of the stock. Based on independent valuation they will sell when the price is too high and buy when the price provides a low risk opportunity. If investors purchased fundamentally strong stocks at attractive prices during 2011-2012 when the market experienced a downward trend they would have gained significant profits with the upward surge we have been experiencing. Similarly the slight drop in prices during the last few days would spout ideal opportunities for value investors.

Are you competent enough to steer your ship of investments when the tide is rough? The rest of the article will give you additional tips to shield yourself in volatile markets.

FLED: Maximizing returns in volatile markets

Figure 2: FLED



- ✓ **Fundamental Analysis**

"The individual investor should act consistently as an investor and not as a speculator."
- Ben Graham

Fundamental value strategies are an important part of investing. These tools can guide you away from overpriced investments that are prevalent at market tops. The importance of fundamental analysis is felt most during a downward trend. If we look into the recent past fundamentally strong stocks listed on the CSE performed reasonably well when other stocks stumbled down. Many refrain from fundamental stocks as they generate long term returns. Yet these are the less volatile stocks and would be an ideal buffer against volatility.

✓ **Invest for long term**

"***Over the long term, the stock market news will be good. Stocks have always come out of crises".***

- ***Warren Buffet***

To help calm the disturbances caused by short-term fluctuations, it's best to focus on long-term. Market volatility decreases over time. Thus the risk also reduces with time. Investors should not enter highly liquid counters that lack fundamental value expecting short term returns. It is only then that your portfolio will be exposed to the undue risk. Above all thinking short term will prevent you from gaining higher returns in the long run. The growth of nearly 300% in the CSE during the last 5 years is a classic example for this.

✓ **Endurance**

"Endurance is not just the ability to bear a hard thing, but to turn it into glory."
-William Barclay

If you are to be a frontrunner in the market you need a strong strength of character. You should be able to withstand market booms and crashes by detaching yourself from emotions while giving prominence to rational thinking. **As Paul Samuelson** once said**"Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas".** If you think that investing is gambling, you're wrong. The work involved requires planning and patience. It requires a great deal of commitment from your part. Apart from the above stated you should expand your knowledge in order to take informed and rational decisions. In most cases ignorance is the root cause for us to act impatiently in the market. If you are able to endure the test of investing the gains you would see over time are indeed exciting.

✓ **Diversification**

"We all have to expand our capabilities to encompass the changing world, its growing diversity and, indeed, its complexity".
-Lachlan Murdoch

One way to protect yourself from market downturns and thereby reduce risk is to diversify. First, consider spreading your investments across different types of stocks. The ideal portfolio would give prominence to fundamental stocks and stocks that give higher dividends while giving less prominence to trading stocks.

The beta value of a stock is another aspect you could look into when you diversify. Beta is calculated using regression analysis, and you can think of beta as the tendency of a security's returns to respond to swings in the market. A beta of 1 indicates that the security's price will move with the market. If the beta is less than 1 the security will be less volatile than the market. A beta of greater than 1 indicates that the security's price will be more volatile than the market. For example, if a stock's beta is 1.2, it's theoretically 20% more volatile than the market.

Warren Buffet, one of the greatest investors the world ever saw correctly mentioned that games are won by players who focus on the playing field –- not by those whose eyes are glued to the scoreboard. Returns are important. Yet it is even more important to master the skill of investing. It is only then that you would be able to realize your financial aspirations. The greatest test of an investor’s skill is when he is in amidst of volatile markets.