Unicorn Financial Solutions Pte Ltd
538 Geylang Road #02-09
The Arizon Singapore 389493
Tel: (+65) 6887 3885
Website: www.unicorn.sg

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Does Volatility Equate Risk?

"The market was very volatile today."

Is Volatility the same as Risk? Does volatility in the markets mean losing money and taking a big hit as depicted by the dishevelled man in the picture [3] above?

Let us see how these two terms are defined:

Volatility: An emotional barometer [1]

Risk: The probability of loss

After reading the two definitions, how has that changed our understanding of Volatility and Risk and how could we use them to our benefit?

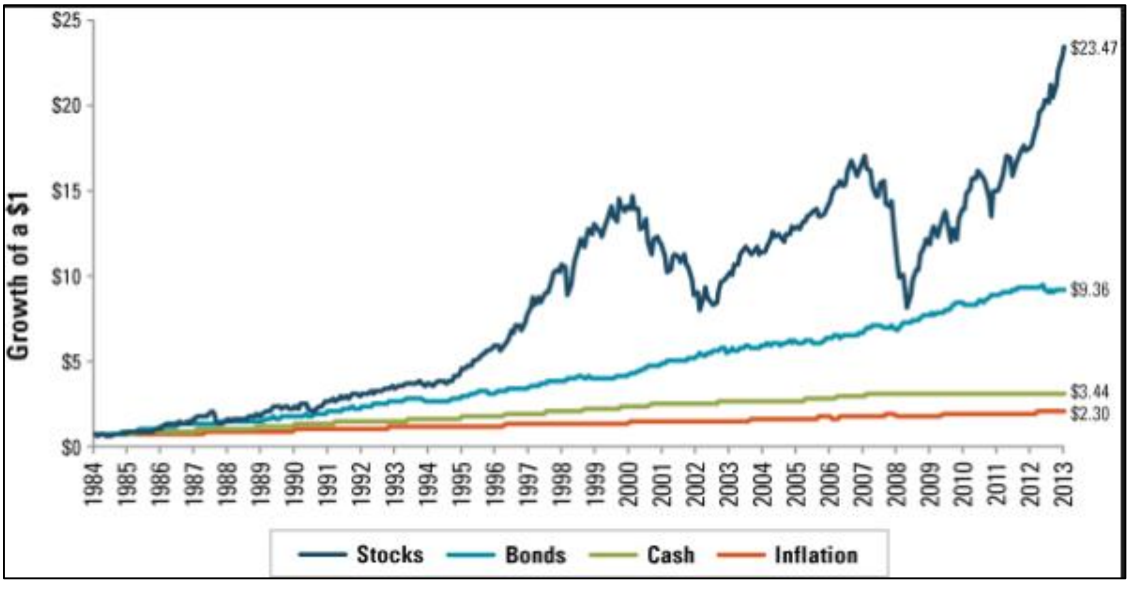
Let us use an analogy: If we're riding on a roller coaster, there will definitely be scary ups and downs (volatility) throughout the entire ride, but do we unbuckle ourselves and jump out of the ride midway? Of course not! We will ride out the entire journey amidst screams and shouts and eventually we will arrive at our destination safely.

That being said, does that mean that there is no risk when riding a roller coaster? No, the risk is still there. For example, the tracks may derail, the emergency brakes may fail, just to name a few. And when we see a sign that states: "Roller Coaster under Maintenance", do we still ride on it? Definitely not; as it would be an extremely dangerous thing to do.

What we are trying to illustrate is that the thrill and excitement (or fear and shock for some) coming from the roller coaster ride has nothing to do with the risks associated with equipment failure. [1]

However, most people do not adopt this approach in their investing journey. More often than not, they will "eject" themselves from their investments prematurely the moment they face some form of emotional volatility without riding it out till the end of their journey which was the initial plan.

Warren Buffet said this in his most recent annual letter to his shareholders, "Stock prices will always be far more *volatile* than cash-equivalent holdings. *Over the long term*, however, currency-denominated instruments are *riskier* investments — *far* riskier investments — than widely-diversified stock portfolios that are bought over time and that are owned in a manner invoking only token fees and commissions. That lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is *far* from synonymous with risk. Popular formulas that equate the two terms lead students, investors and CEOs astray." [2]



The chart [4] above shows both the characteristics of stocks and bonds. As we can see, stocks experience more volatility or "ups-and-downs" as compared to bonds, but does this mean that the stocks of a company are riskier than its bonds?

Although the volatility of stocks and bonds are very different, their risks are similar. The risk is dependent on the stability of the company which issues the stocks and bonds. When the company does well, both its stocks and bonds are safe, however, when the company faces problems, both its stocks and bonds are risky.

Volatility and Risk are not interchangeable [1], and it would be disastrous to your investment portfolio should these terms be misunderstood or even applied wrongly.

More often than not, market noises coupled with the media cause our emotions to swing like that of a roller coaster ride. Therefore it is crucial that we are able to focus on our destination rather than on our emotions and ride out the entire journey.

An investor's financial wisdom is critical to his success in investment. When the investor grows in financial wisdom to see Volatility as distinct from Risk, his success in investment follows. Warren Buffett also mentioned: "Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it."

In Unicorn, we strive to grow with friends like you in our financial wisdom, so that we will always jump for joy when there is Volatility in the stock market as we are eager to profit from these rare opportunities for our friends. As we achieve this, the journey to being wealthy is paved with joy and bliss.

Reflections
How often have incorrect investment choices been made due to emotional volatility?

How have I reacted during stock market volatility in the past?

a) I watched the price of my investments intensely and hoped for the price to rise quickly so that I can redeem my investments and end my worries – **Average investor**

b) I felt uncomfortable but I held on to my investments as I know I should not sell my investments when prices were depressed – **Disciplined investor**

c) I felt excited and invested more (or called my financial consultant to help me invest more) as I understand that it was an opportunity not to be missed. As prices dropped, I kept on investing more – **Wise investor**

d) I never had to monitor the price of my investment, I have carefully selected a trusted investment adviser and hence followed exactly what he told me to do – **Blessed investor**

How would I like to progress as an investor?

Prelude to next article: Difference between price and value. The focal point that sets successful and failure investors apart.

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[1] "Investing Risk and Volatility Aren't the Same"
http://money.usnews.com/money/blogs/the-smarter-mutual-fund investor/2013/06/07/investing-risk-and-volatility-arent-the-same

[2] "Volatility is not the same thing as risk, and anyone who thinks it is will cost themselves money"
http://www.businessinsider.sg/warren-buffett-on-risk-and-volatility-2015-4/#.VUmSodGJjIU

[3] "The market was very volatile today."
https://www.cartoonstock.com/directory/v/volatile.asp

[4] "Standards and Poors, Stocks for Growth Potential and Inflation Protection."
http://fc.standardandpoors.com/ondemand/public/content/tutorial/view.vm?hnd=208&client=pruden&page=8

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