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INVESTMENT MANAGERS

Prudential Investment Managers

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What you need to know about market volatility

What goes up, must come down – it's a basic law of gravity. When it comes to investing, markets rise, and markets fall. The extent to and frequency with which they do so, is called 'volatility'.

This is obviously an important consideration for investors, particularly those relying on their investments to provide them with a regular income, like retirees. If an investment constantly moves up and down in value, so will the amount of income it's able to produce.

So important is the concept of volatility in investing, that it's strongly linked to the performance of investments. After all, volatility implies risk: the risk of not meeting an investment objective or not having enough income; the risk of losing money.

Investors understand that investing involves risk, but they want to be compensated for the amount of risk they take. Which is why fund managers will report on the 'risk-adjusted performance' or 'risk-adjusted returns' of their funds. In other words, what risk was taken to produce a certain return? It also provides insight into how different portfolios behave under different market conditions.

In most cases, the higher the volatility of an investment, the higher the risk. And the reverse also applies.

The four main types of assets you can invest in – shares, bonds, property, and cash – have different risk profiles and accordingly different return profiles. Shares have been the best performing asset over time; but they also come with more risk than the other three types, or classes, of assets. Cash has the lowest risk profile, but also generally produces the lowest returns over the longer term.

Time heals all wounds

Another important thing to understand when thinking about volatility is the impact of time. If your investment horizon is short, in other words you need to withdraw your money in just a few years, a high level of volatility can do a lot of damage to your capital. But if you only need your money in 20 or 30 years, you're able to withstand higher volatility levels, as volatility smooths out over longer periods of time.

Measuring volatility

To assess the volatility (or risk) of an individual investment or fund over time, the investment industry uses two main tools: the Sharpe ratio and the Sortino ratio.

Developed by Nobel Laureate William F. Sharpe, the Sharpe ratio helps investors understand the return of an investment relative to its risk. It is generally the industry standard. It considers any movement in the performance of an investment or fund, up or down, in relation to the average, as risk. One wouldn't think that outperforming the average is a risk, but in professional investing it's important as it impacts the fees managers charge for managing a fund. Generally, the higher the Sharpe ratio the more attractive the risk-adjusted return.

The Sortino ratio is a variation of the Sharpe ratio, and was invented by Frank Sortino, a Professor of Finance Emeritus at San Francisco State University. The Sortino ratio only looks at 'bad' volatility, or the risk of losing money. A higher ratio indicates a better return, relative to downside risk. If you're interested in understanding these two ratios a little better, we've written an article that explains them in more detail.

Which measure is best for you to focus on?

For most individual investors, the risk of losing money is the most important risk – so the Sortino measure would be your best bet. But remember, throughout the course of any investment, volatility really only matters at the end, when you cash in your investment, or start drawing down an income. Until then, the gains and losses you've made are only on paper, not in your pocket.

For more information, please feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.