TEMPORARY MARKET DECLINES

A century ago, the famous linguist Edward Sapir noted that societies use language based on how they interpret the world around them. Today, this observation is apparent regarding an often-misunderstood word in investing: volatility.

In general, investors interpret the word volatility as sudden, sharp, downward movements in stock prices. However, it doesn't mean that at all, and by itself, volatility doesn't cause anyone to lose money.

What volatility actually refers to is the rate at which stock prices move up or down given a certain time period. This figure is compared to longer-term trends to determine the extent to which price movements have deviated from the norm.

> Morningstar/Ibbotson research reveals that since 1926, large-cap stocks have grown at an annualized rate of about 10% (compounded). Corporate bonds have grown about 6%, and inflation has increased about 3% respectively over the same time-period.
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> More interesting is the fact that there is no rolling 20-year period (beginning from the first of every month) since January 1926 where the S&P 500 has produced a negative return (assuming dividends were reinvested). In other words, the asset class with the most volatility has produced the highest level of returns for close to a century.

Given this definition, volatility has neither a positive or negative connotation. When a stock price significantly fluctuates (whether up or down) in a relatively short period of time, it is said to be highly volatile. Conversely, if a stock price fluctuates slowly and steadily, it is said to have little volatility.

Equity markets could be up 10% one year and down 10% the next, while bond markets will likely experience much less price fluctuation. This simply means stocks are more volatile than bonds. More importantly, a long-term oriented investor must look beyond the higher volatility of equities if they are to achieve superior long-term returns.

This means that to properly understand volatility, one must also recognize the necessity to accept it as a part of successful long-term investing. In fact, Warren Buffett has noted that opportunistic investors prefer volatility, as it provides more attractive buying opportunities over time. The key is to avoid fear-based selling based on downward volatility.

Such advice is handy the next time a market correction occurs, and the financial media pounces on an opportunity to sound the alarm on volatility. Volatility is not the same as risk, and temporary market declines are not the same thing as permanent losses, unless and until an investor sells.

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September 5, 2019