

Is Volatility Risk? The Bad Influence of Academia to the Discussion

George Athanassakos*

Ivey Business School, Western University, Canada

Finance academics define risk as volatility, whereas value investors define risk as the probability that adverse outcomes in the future will permanently impair the cash flow potential of a business leading to permanent (long run) impairment of capital. Which is the right definition? It all depends on your investment horizon. But if maximizing terminal wealth is of importance to investors, and it is difficult to argue otherwise, then the latter is the right way to look at risk. In this sense, academia may be bad for an investor's wealth and prosperity.

Let me explain why.

There are two types of fundamental analysts: short term and long term. Short term fundamental analysts are the typical financial analysts. They accept the stock price as given and try to determine what will make the stock price move. Their price targets and investment calls are impacted by the release of short term economic and corporate news. They react to such announcements. Value investors are long term fundamental analysts. They do not react to short term announcements as they have long term horizon. For example, the short term noise of whether the next quarter's earnings deviate from expectations is immaterial and hence causes no reason for reaction. What is material for value investors is whether the company continues to have strong fundamentals, be well managed and financially sound, as well as "cheap". The stock price plays no important role for value investors; instead it is the difference between the intrinsic value and the stock price that is of importance. If the stock price is significantly below the intrinsic value (by a predetermined margin of safety) then the stock is "cheap" and value investors buy, otherwise they wait.

The investment horizon plays key role in the discussion of what is an appropriate measure of risk, because different horizon investors assess risk differently.

Markowitz defined risk as the standard deviation of returns (volatility) [1,2]. Sharpe, on the other hand, argued that in a well-diversified portfolio the only risk that matters is beta risk. Both professors shared (along with Merton Miller) the 1990 Nobel prize in Economics and have had a lasting impact on academia and the notion espoused by short term fundamental analysts and academics that short term fluctuations in the value of a portfolio are important and the only risk that matters [3].

But truly how much should an investor worry about this short term volatility? Not much. As Munger [4], Buffett's partner at Berkshire Hathaway, explained during a speech he gave at the University of South California's Business School "if you're investing for 40 years in some pension fund, what difference does it make if the path from start to finish is a little more bumpy or a little different than everybody else's so long as it's all going to work out well in the end? So what if there is a little extra volatility?"

Recent research by Estrada [5] bears this out. Estrada concludes that "Investors should learn about the detrimental impact of reacting to short term volatility and focus on the end game instead". He shows that in the US, the mean terminal wealth of investing in stocks over a 10, 20 and 30 year period is 59%, 146% and 299% higher than investing in bonds. In Canada, the corresponding figures are, 41%, 88% and 131%.

For the world markets they are 49%, 116% and 231%, respectively. It is true that the volatility of terminal wealth across all holding periods is found to be higher for stocks than bonds in every market examined and thus stocks are riskier when risk is measured by volatility. But interestingly enough the higher volatility of terminal wealth from stocks is mostly on the upside. According to Estrada's findings, stocks have both higher upside and more limited downside than bonds.

Why then are stocks viewed as riskier than bonds? It may be the wide acceptance of volatility as a measure of risk at Universities and academia's influence on the CFA program. There could also be institutional, as well as behavioral reasons.

In a perfect world, both the investor and the mutual fund manager will have long term horizon and volatility would play no important role. But what if the investor has a short term horizon and detests (panics in the face of) short term volatility? In this case, the mutual fund manager will have to consider short term volatility if he does not want to lose funds under management and possibly his job. He will have to abide with the desires of the investors and also focus on short term volatility, thus contributing to the focus of the mutual fund industry and financial analysts on the short term.

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*Corresponding author: George Athanassakos, Professor of Finance, Ivey Business School, Western University, Canada, E-mail: gathanassakos@ivey.uwo.ca

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