INVESTING IN A VOLATILE MARKET

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“As the sole measure of risk, share price volatility has been a bugbear of mine since I studied economics at university. It simply made no sense to me that a company whose share price was volatile was necessarily riskier than one with a stable share price.”

Steve Johnson, Chief Investment Officer at Forager Funds

“Risk adjusted returns”. That’s one of the more common phrases you will see on fund manager websites. It is, after all, what we are all trying to do: maximise returns and minimise risk.

The return part of that equation is a straight forward number. But how do we measure risk? And who am I minimising risk for? They are not easy questions to answer. Certainly not as easy as the industry would have you believe.

At Forager, we welcome volatility in the market. We believe it can provide opportunities to invest in businesses we would otherwise not be able to own due to the share price being deemed too high.

For example, the market crash and subsequent volatility in March 2020 allowed us to add Autodesk (Nasdaq:ADSK) to the Forager International Shares Fund portfolio. This was a business we’d had our eye on for a while, but the share price had increased during 2019, making it too expensive in relation to our valuation of the company, to buy at that time. The market crash gave us a second chance to purchase shares in this high quality business when it traded in the market at much lower prices.

Embracing volatility in this way has allowed us to make some great investments during 2020.

Here are our tips about things you should think about when considering making investments during volatile market conditions.

Volatility is not risk for everyone

Firstly, your time horizon is crucial. If you need to sell your shares next week, then stock price variability is a significant risk for you. If you have the capacity to hold an investment for 5 or 10 years, what happens next week doesn't matter.

Secondly, volatility is itself a variable. A stock that has historically shown very little volatility can become highly volatile, and vice versa. Look no further than the March 2020 meltdown, where shares in airports went from trading like infrastructure safe havens to highly volatile tourism stocks.

Volatility is a risk for someone who needs to sell. For someone who wants to buy, it can be an appealing feature of an investment. And for an investor with a long time horizon, volatility can be more friend than foe.

Low prices equal lower risk

We want to buy shares at highly attractive prices. Almost by definition, the more a share price bounces around, the more chance that, at some point in time, it trades well below its fair value.

Further, the smaller the gap between your purchase price and fair value, the higher the risk that fair value is less than your purchase price over the long term.

Higher volatility can actually reduce risk when making an investment due to it being more likely that you are able to purchase shares at a low price in this environment.

Share price does not necessarily mean anything has changed at the underlying business

It is important to remember that the price is simply the level at which supply and demand meet. While it often represents a fair reflection of a business's prospects, that doesn't have to always be true. Sometimes the sellers simply need cash and will take any price they can get. Sometimes the potential buyers are far more fearful than usual. When desperate selling meets reluctant buying, the clearing price is going to be a lot lower than it would otherwise be.

In a market meltdown especially, expectations are already low, and those low expectations meet a crescendo of forced selling. Investors are panicking, super funds are suffering withdrawals and funds are meeting client redemptions by selling the underlying stocks. These flows can cause the clearing price to vary dramatically from even the most pessimistic investors' expectations about the future.

All of this is unrelated to the underlying business itself. If that business is still solid, generating cash and looks like it will be a going concern for years to come, then it could be a great investment.

Genuine opportunity for risk-adjusted returns

Market volatility can be stomach churning. It’s hard to enjoy your breakfast when reading about the billions of dollars “lost” on global share markets.

But, if you’re a Forager client or a long-term investor, you should welcome it. With volatility come some genuine opportunities for risk-adjusted returns.

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Finding opportunity in unlikely places

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