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Understanding volatility

What is it?

Volatility refers to the unpredictable and relatively rapid changes in the price of an asset. The purpose of this document is to give readers the right framework for understanding volatility, specifically as it applies to stock prices, so as to use it to one's advantage. Let us understand the reasons and causes of stock volatility.

What causes volatility?

1. Stocks are generally more volatile than fixed income instruments like bonds, T-Bills etc. The value of a company's stock is the sum of discounted cash flows earned during the life of the company. The variables in this equation, namely discount rate & cash flows, are in turn, changing every second. The discount rate depends on the inflation, Fed funds rate, risk premium etc. A company's prospects change all the time, and as a result, so do the free cash flows that can be taken out of the company. The estimates of cash flows far into the future is more uncertain than the cash flows estimated in the next quarter.
2. The market participants (institutional money managers, advisors, analysts, individual investors, traders etc.) are constantly estimating or guessing the values of the discount rate and cash flows. These estimates are also constantly revised.
3. Risk premium is the return you expect in excess of a risk-free asset. In a bull market, the risk premium is revised downward, and stock prices are bid up. In a bear market, investors get risk averse and stocks are bid down, thereby increasing the risk premium.
4. In an expanding economy, companies become more profitable. The range of earnings estimates vary widely, and this variation is reflected in the volatility of the stock price. You might see wild swings before and after the earnings release.
5. Market is a forward pricing engine. All the future estimates of discount rate and cash flows are priced in. If the Fed changes their outlook of the interest rate, and if the change is not already priced in by the market, the revised outlook gets slowly or abruptly reflected in the stock price. This can cause volatility.
6. The investors of a company's common stock may have different holding periods. A pensioner might be selling stocks monthly to generate income, a young investor may be doing monthly addition of a stock, a 401K participant might be blindly buying an index fund that holds these stocks. A trader might exit a stock after a pre-defined appreciation or a loss. All these trades cause volatility.
7. Funds generally hold stock based on a predefined criterion. They may the focus on size of the company, industry, sector, valuation etc. If a company moves from small cap to mid-cap, the funds of the former will sell and latter would add. This can cause volatility.
8. Analysts frequently downgrade or upgrade a stock. Sometimes the timing is suspect and is done to aid their clients to buy or sell the stock at the opportune times. This causes tremendous volatility.
9. Risk premium, and hence volatility, can also be affected by external shocks and macro factors, such as, the corona virus pandemic of 2020 and the US-China trade war that began in 2019.

Practical case:

Let's take the example of Amazon. Amazon has had a remarkable performance since its IPO. It has gone up 12,040%. On the flip side, it has been the most painful stock to own. Look at the yearly drops. The declines

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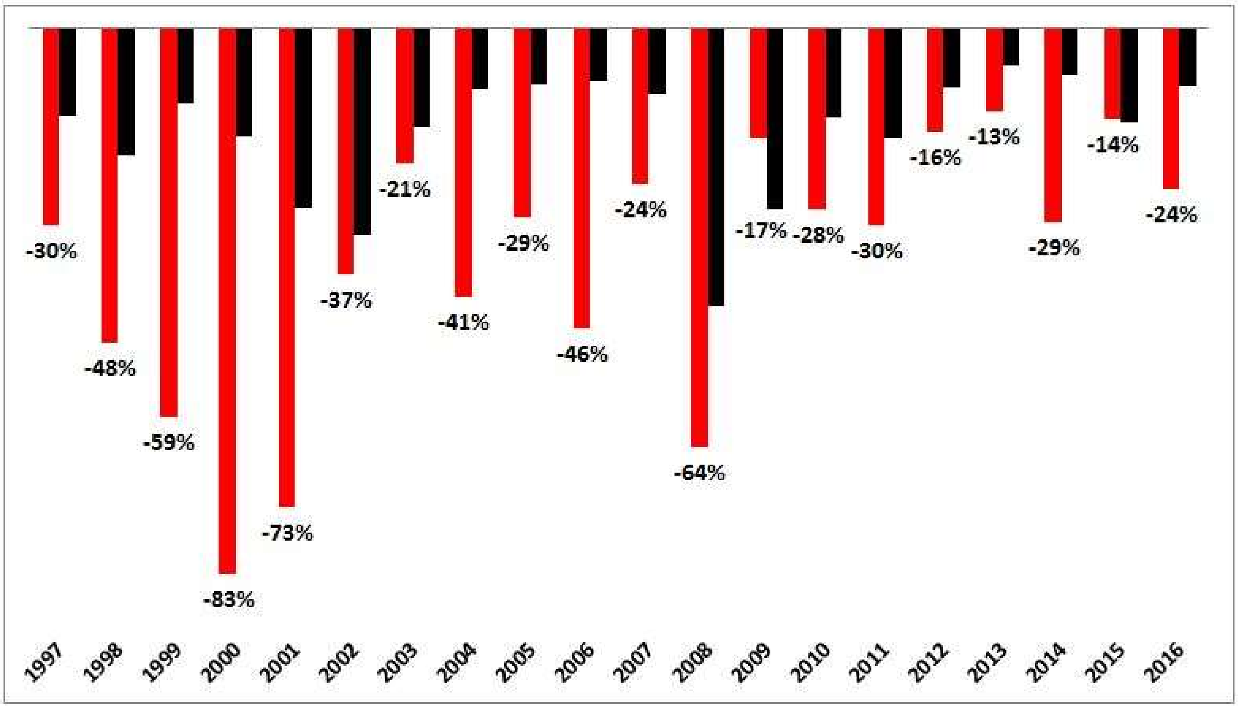
(red=Amazon, black=S&P 500) have been much worse than the general market index. It takes a lot of courage and conviction to own such a stock through painful periods.



Key takeaways:

1. In general, volatility may not be related to the future prospects of the company.
2. Volatility if understood right can be exploited to your advantage.
3. For a long-term investor, it is better to ignore volatility and keep the focus on the fundamental prospects.
4. Volatile stocks are not risky stocks in general.
5. Volatility may not result in permanent loss of capital. It results in a paper loss on a day to day basis. Market beating gains may be realized if an investor is willing to ignore the day-to-day price fluctuations.