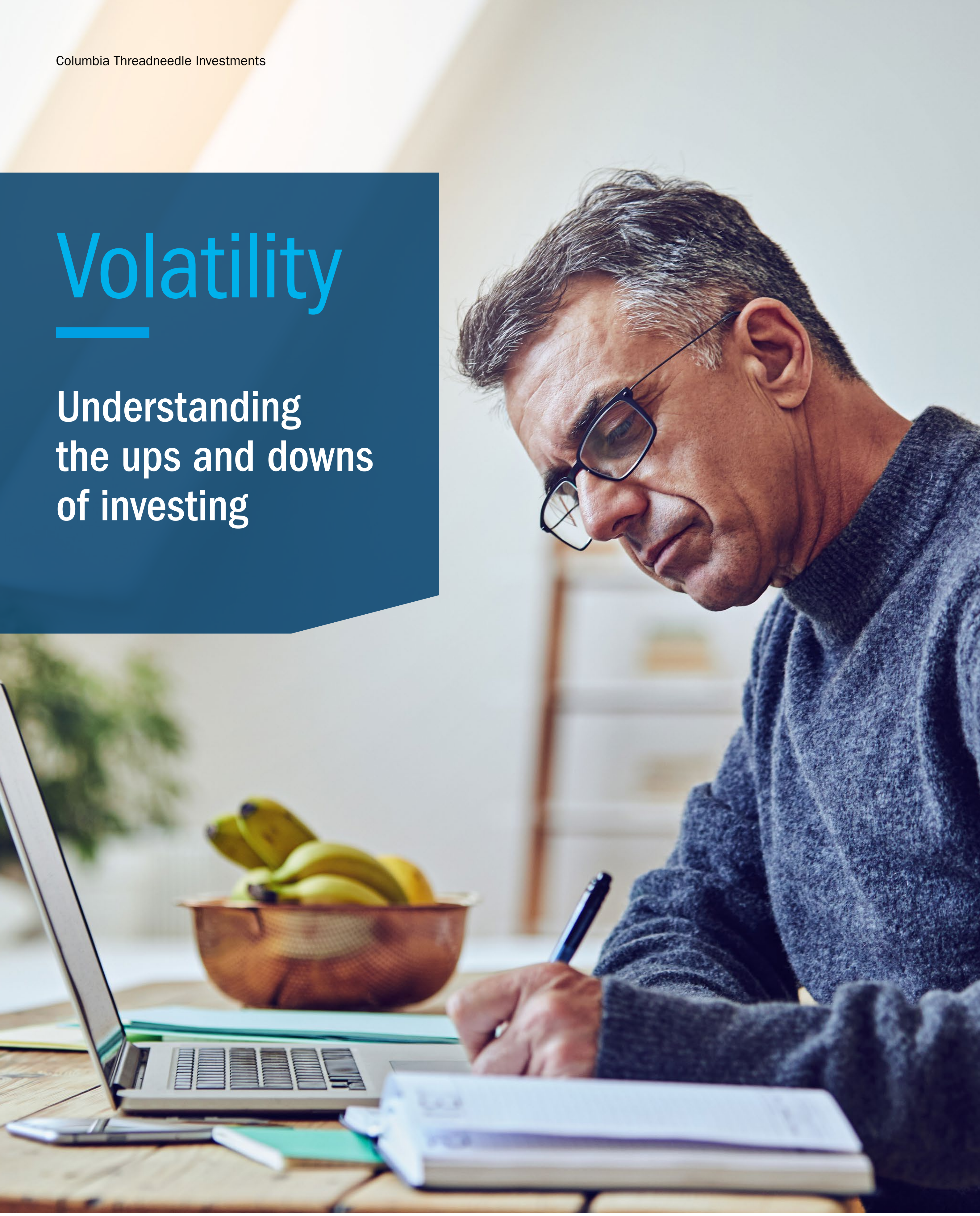
Volatility

Understanding the ups and downs of investing



COLUMBIA THREADNEEDLE INVESTMENTS

Volatility – understanding the ups and downs of investing

Volatility is a feature of virtually any investment type, meaning the journey towards your long-term financial objectives is likely to contain ups and downs along the way. Here we take a closer look at volatility, the importance of time and the power of diversification.

Investing in anything other than cash is a medium to long-term commitment – that means at least 3-5 years – but considering that an average economic/market cycle takes around 7 years to fluctuate between growth and recession before coming full circle, perhaps that's a more reasonable timescale. But why does time matter?

First, it usually takes time for an investment to come to fruition. If you buy shares in a company on the basis that it looks well placed to prosper in the future, then it's logical that it'll take time for that potential to be realised. After all, very few businesses are an overnight success.

Volatility – a normal feature

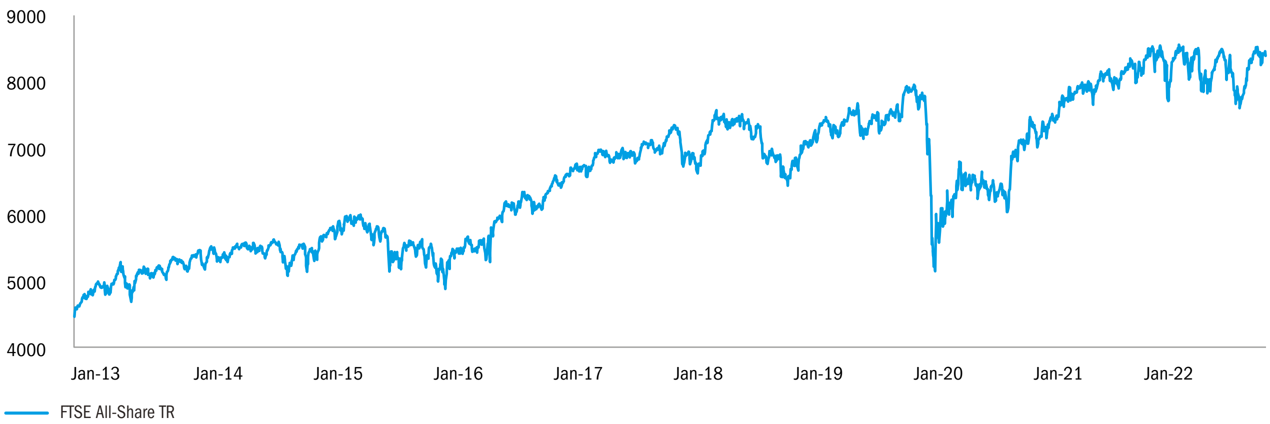
There's another reason for taking a long-term perspective – something called volatility. Look at a chart of the UK stock market's performance over 10 years – the trend is upwards and had you invested at the start of 2013 the chances are you'd have made decent gains along the way. Over shorter periods though, the market has experienced more pronounced ups and downs.

In simple terms, volatility is a measure of the size of short-term changes in the value of an investment. Volatility is a feature of virtually all investment options and whilst the long-term outcome may be a positive one in terms of returns, the journey is likely to be one that contains ups and downs along the way.

There are no guarantees of course, and volatility may mean that you may not get back the original amount invested when you decide to withdraw your investment.

"In simple terms, volatility is a measure of the size of short-term changes in the value of an investment."

UK stock market's performance over 10 years



FTSE All-Share total return. Source: Lipper, as at 31-Dec-22

Past performance should not be seen as an indication of future performance.

The power of perseverance – time in the market

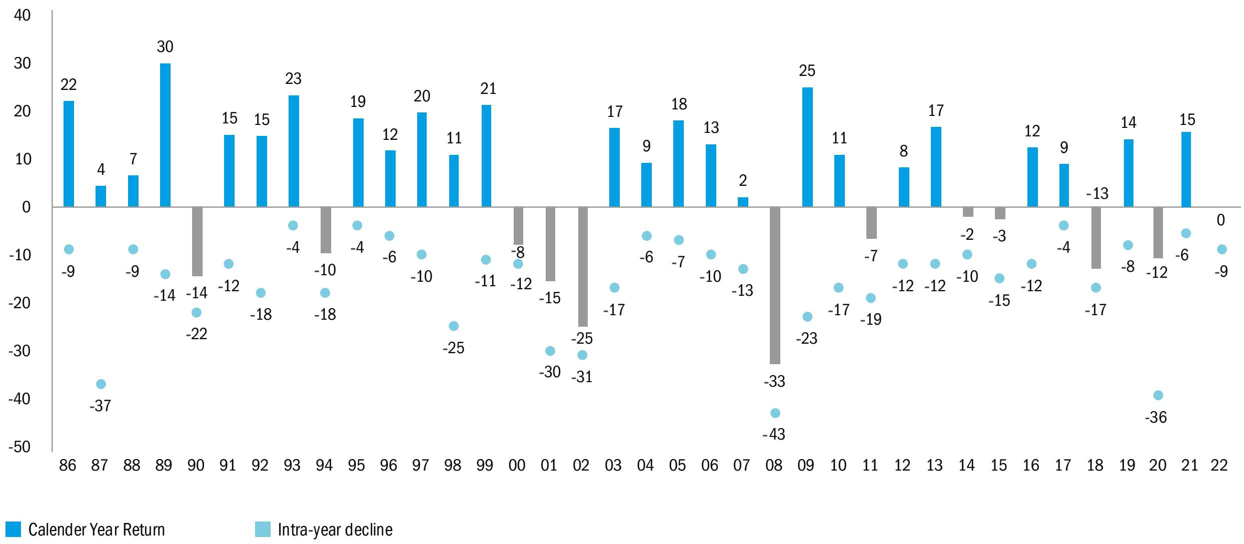
Time is important because a longer time period smooths out the influence of volatility.

Episodes of volatility triggered by a variety of factors can be significant. In the bar chart below we look at the performance of UK shares in calendar years between 1986 and 2022. 26 of the 37 years have seen positive returns, but there are years in which shares have fallen sharply. The message is clear – had you invested for an extended period, the chances are that years of positive returns will outweigh periods of disappointment.

There's even more stark evidence of volatility within calendar year performances. 26 of the last 37 years have seen large falls (of 10% or more) in the market during some part of the year. However, in more than half of these 26 years, the market has regained its poise and finished the year in positive territory. Volatility is a clear feature of investment in UK equities, but time and again it has paid dividends to put short-term fluctuations in context and focus on the timescale that really matters – the longer-term one.

The merits of 'time in the market' are readily apparent – participate in the long-term potential of investing and you have more of a chance of riding out the fluctuations that happen along the way.

FTSE All-Share intra-year declines vs. calendar year returns



Source: Columbia Threadneedle Investments. Returns shown are price returns in GBP. Intra-year declines refer to the largest peak to low within a calendar year, as at 31-Dec-22.

UK shares in calendar years between 1986 and 2022

1986

26 of the 37 years have seen positive returns

2022

Time not timing

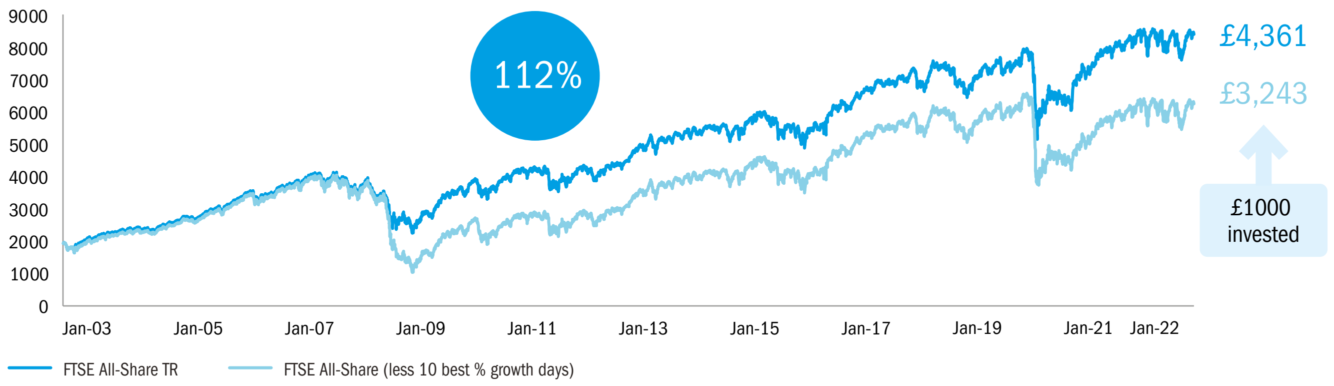
But is it possible to time the market? Investment 'nirvana' would be the ability to invest during periods when prices were trending upwards whilst avoiding times when there's a downward correction.

20 years – the impact of missing the 10 best % growth days

In the absence of a crystal ball it seems an unlikely ambition, particularly when you consider some of the unpredictable factors that can affect markets – how many predicted the global financial crisis in 2008 or the tech bubble bursting earlier that decade? More recently we've seen markets swing sharply in the short-term due to the impact of the COVID 19 global pandemic.

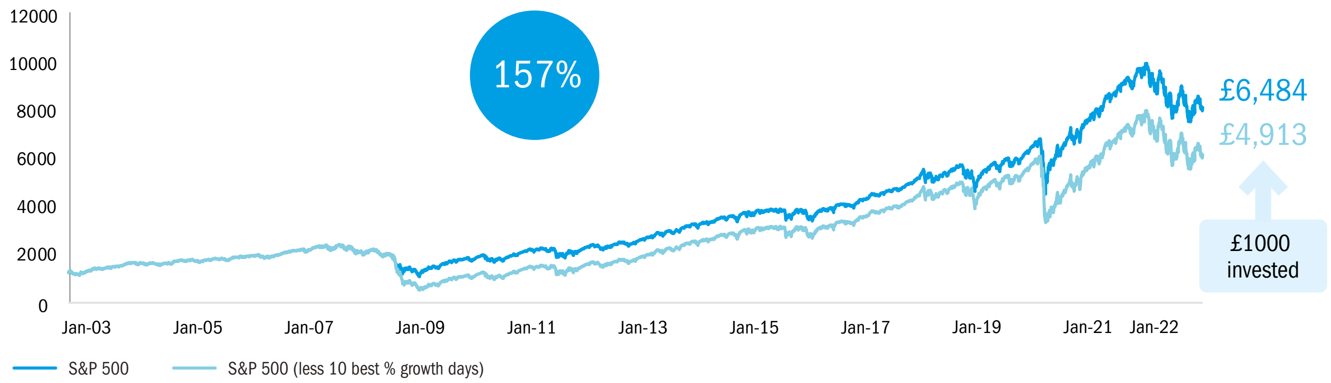
Trying to beat the market by taking short-term positions to avoid losses is unlikely to be a successful strategy and the flip side is the cost of potentially missing out on the days when markets do rise strongly. Just look at the difference in the investment outcome had you missed out on the 10 days in which the market performed the strongest…

FTSE All-Share



Source: Lipper, as at 31-Dec-22, sterling, total return.

S&P 500



Source: Lipper, as at 31-Dec-22, sterling, total return.

Past performance should not be seen as an indication of future performance.

Back to basics – diversification matters

So, volatility is part and parcel of investment and given enough time its effect can prove to be relatively limited.

It can, however, make sense to consider ways of countering the impact and extent of short-term moves. Ahead of realising an investment for example, significant downward fluctuations in value would obviously be unwelcome. Similarly, specific financial circumstances can make individuals more or less accepting of volatility.

Diversification is a proven principle for generating returns in a more consistent and reliable manner. It's a simple concept: asset classes (like equities, bonds and property) have different characteristics so by spreading your investments across a number of them it's possible to participate in a broad range of opportunities whilst smoothing out extremes in terms of positive and negative performance.

In this chart the performance of asset types can be seen to vary markedly from year to year – a top performer can see its fortunes swiftly reversed in the following 12 months. Holding a blend of assets, however, can be shown to limit extremes of performance – an approach that can result in a smoother journey towards the investment outcome you're trying to achieve. The data below reveals that a portfolio invested in equal amounts of the different asset classes would have produced an average annual return of 5.99%.

Pin the tail on the donkey – asset class performance varies year on year

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Best	30.67	17.72	15.86	31.65	25.16	3.25	24.66	20.08	25.69	1.28
	26.65	14.89	9.58	30.82	24.70	0.43	22.50	16.33	18.45	-1.95
	26.40	10.98	9.57	25.91	17.67	-0.06	20.34	13.89	17.16	-7.03
	26.20	10.57	6.40	23.47	17.33	-1.32	19.90	13.72	15.61	-8.07
	25.66	9.71	4.91	16.81	14.08	-2.16	17.18	10.48	7.32	-8.24
% Annual Returns	12.14	6.13	4.90	15.29	11.73	-3.50	15.82	8.98	7.01	-9.19
	8.30	3.48	3.31	12.54	11.39	-5.80	15.78	7.74	4.35	-9.24
	6.88	2.95	0.47	11.58	10.08	-9.76	13.68	6.08	1.70	-9.62
	2.09	2.35	0.25	11.19	7.54	-10.50	11.48	3.57	1.37	-9.89
	1.39	0.75	0.24	9.75	5.78	-11.18	9.51	0.43	-0.05	-9.98
	0.35	0.64	-0.02	8.84	5.13	-11.34	6.90	-5.29	-0.32	-12.40
	-3.99	0.26	-3.06	0.48	1.74	-11.39	0.72	-6.21	-1.90	-16.32
Worst	-4.93	-0.78	-9.37	0.39	0.18	-12.06	-0.59	-10.78	-5.28	-24.35

- IA £ Corporate Bond TR
- IA £ High Yield TR
- IA Asia Pacific Excluding Japan TR
- IA Europe Excluding UK TR
- IA Global Emerging Markets TR
- IA Japan TR
- IA North America TR
- IA Standard Money Market TR
- IA UK All Companies TR
- IA UK Direct Property TR
- IA UK Equity Income TR
- IA UK Gilt TR
- Equally Weighted Portfolio

Source: Lipper, as at 31-Dec-22. IA = Investment Association.

> “Holding a blend of assets, however, can be seen to limit extremes of performance – an approach that can result in a smoother journey towards the investment outcome you're trying to achieve.”

Want to find out more?

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