Volatility: Fear Thou Not

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To paraphrase Darwin,

> "It is not the most intelligent of investors that prosper, nor the most optimistic that prosper. Prosperous are the ones that handle volatility the best."

What do we mean by volatility?

Academic finance describes volatility as Beta (β) or fluctuation in price of security with respect to the market. There is a formula to calculate Beta. There is variance, co-variance, standard deviation but β doesn't account for intrinsic value of the security. If price of security changes more than the underlying market, β is high and the security is assumed to be riskier and vice-versa.

Is it correct to assess riskiness of a security without ascribing to its intrinsic value? I never understood β. I memorized its formula exactly for a day when I appeared for an exam in financial management and forgot it the moment I stepped outside the examination hall.

How do I think about volatility?

Volatility for me is the change in price of the security- measured with respect to its intrinsic value. The change can be up or it can be down. It can be gradual or it can be sharp.

If the security becomes cheaper with respect to its intrinsic value, the investment become less risky no matter what the β is. And that is the time to buy more of it -within the limits of prudent position size.

Volatility — How sharp can it be?

The below data from Bombay Stock Exchange shows that when volatility (downside) strikes- prices can fall precipitously from a cliff. In the period [1990-2011], Indians markets witnessed 3 instances of BSE Sensex dropping by more than 50% from its peak and additional 3 instances where the markets dropped by more than 25% from their peak levels.

Date	Sensex Close		Date	Sensex Close
9-Oct-1990	1559.43		11-Feb-2000	5933.56
25-Jan-1991	956.11		21-Sep-2001	2600.12
Drop during the period	(39%)		Drop during the period	(56%)
22-Apr-1992	4467.32		08-Jan-2008	20873.33
27-Apr-1993	2070.71		09-Mar-2009	8160.40
Drop during the period	(54%)		Drop during the period	(61%)
06-Aug-1997	4523.01		05-Nov-2010	21004.96
01-Dec-1998	2804.03		20-Dec-2011	15175.08
Drop during the period	(38%)		Drop during the period	(28%)

How do I handle volatility?

To handle volatility, I think in terms of firewalls. Just like firewalls help to protect our machines from malicious software, we can design firewalls to protect our portfolio and our sanity in times of volatility. I have constructed 3 layers of firewalls around my portfolio.

Firewall 1: Liquidity at the personal level

I keep a liquid reserve of money in the bank – every time and always. That reserve is meant to take care of family living expenses for a certain number of years, if the markets were to hit a rough patch. That money is not available for investing.

"At the time of severe market disruption, cash is like oxygen. When you don't need it, you don't notice it. When you do need it, it is the only thing you need." –Buffett

It seems simple but it is hard to practice. Investing annals have examples of even renowned investors who have found themselves in the centre of liquidity crunch. They had to sell their carefully chosen good investments at precisely the wrong time to tide over the crisis.

I feel that lack of liquidity robs us of the capacity to think clearly. Keeping a certain portion of money aside, quells any kind of anxiety- for me. This calm state of mind then helps me to think carefully about the money which is available for investing.

This reminds me of famous lines by the great poet Rabindra Nath Tagore – "Where the mind is without fear and the head is held high…" So, when my mind is free of any fear, I can think clearly about investments.

Firewall 2: Rock solid business investments

The second firewall I install is that of good quality businesses. I carefully choose good quality businesses which lie within my circle of competence, are managed by high quality people and are available at prices lower than their intrinsic values. Such businesses have the capacity to weather adversities of extreme nature. With a collection of such businesses in the portfolio, I feel that the probability of permanent loss of capital is low. Volatility can provide an opportunity to buy more of such businesses if prices were to become attractive.

I stay away from leverage and stay away from complex investment strategies. I only invest in rock solid businesses which act as the second firewall.

Firewall 3: Psychological firewall

This firewall is abstract and like the competitive advantage of a business — it takes time to build. We need to train and reprogram our subconscious.

Downside volatility hurts the most when investments are marked-to-market.

"Bad terminology is an enemy of good thinking." –Buffett

I believe that mark-to-market is a wrong terminology to think about investments. Do we make investment decisions based on intrinsic values? If the answer is yes- then there is no reason to mark our investments to market prices and sulk when hit by severe price correction.

We should not mark our portfolios to market but we should mark them to intrinsic values. If our investment thesis is intact and we conclude that our investments are selling at discounts to their intrinsic values then the portfolio would be in fine fettle and there will be no reason to worry.

With the help of these firewalls, I prepare myself against volatility. I constantly review my processes with respect to the above and where ever I find gaps in my process, I plug them. With time, I hope this process fortifies my portfolio and my thought process. It's not volatility but our preparedness and our responses to volatility that will determine our portfolio returns.

In the book "I am not an entrepreneur", Mr R Thyagarajan, one of India's foremost business creators talks about his analogy of 'Varappu Uyara'. In Tamil, 'Varappu Uyara' means raising the ridge or walls around a field.

Avvayar, the great Tamil poet-saint blessed her king with high boundary walls in the rice fields. When the walls go up, there are a series of positive consequences: they can hold more water, the harvest is greater, and so is the overall prosperity.

I think just like the king, we (investors) are blessed to create our own walls. May all of us build higher walls, develop the capacity to face volatility, take advantage of it and prosper.