How Less Excitement Makes Us More Money: The Volatility Drag

Saturday's With Jim

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Dear Friends,

Exciting investing is akin to riding a rollercoaster at an amusement park. There is a long, somewhat steady climb to the top and a rapid, terror filled descent to the bottom. Today we dispel the myth that investment excitement is the way to gain solid investment wealth over periods of ten, twenty or more years. Indeed, we showed in our posts of Sept. 9, 2017 and Sept. 23, 2017, a fund that beat the widely known S&P 500 Index in only three of ten years , but went on to outperform it by a slight margin. Why did our fund, Vanguard Dividend Appreciation Index Fund (VIG), earn its shareholders more money than the S&P 500 from 2007-2016?

A Volatile 2008 Made the Difference

SPDR S&P 500 ETF (SPY), a popular S&P 500 fund, dropped 37% in 2008 while VIG only dropped 26%. Suppose the SPY and VIG accounts ended 2007 at $100,000. At the end of 2008, the SPY account was worth $63,000 while the VIG account was worth $74,000. To get back to $100,000, SPY needed to gain 59% while VIG only needed a gain of 35% from the 2008 lows. The yawning 2008 performance gap between SPY and VIG was so large that by the end of 2016 it still had not closed. VIG is only about 90% as volatile as is SPY. You will see below why Steady Eddies like VIG can beat Faster Eddies like SPY when the latter slips badly in a severely prolonged down (bear) market.

Why VIG Outperformed

Because of VIG's higher quality, the earnings of the companies it holds are more predictable and less subject to uncertainty than the earnings of the companies in the market as a whole. VIG's outperformance is attributable to its lower volatility than the market. Why?

Volatility Drag

A stock's volatility is its price movement. The larger the expectation and uncertainty embedded in a stock's price, the more volatility it tends to have. Through a process called volatility drag, the higher volatility, more exciting stocks lose more and more to their lower volatility, more boring and certain, stock brethren.

Given two examples of differing volatility but the same arithmetic average (total return/no. of years) you will see that the lower volatility portfolio outperforms. Both examples below began with $100,000, ran for five years and gained 25% overall when computed by arithmetic average:

Hypothetical Portfolio	Return Year 1	Return Year 2	Return Year 3	Return Year 4	Return Year 5	Growth of $100,000
Higher Volatility	8%	12%	-5%	-10%	20%	$124,105
Lower Volatility	8%	11%	-4%	-5%	15%	$125,730

Volatility dragged the higher volatility portfolio down $1,624 lower over the five years. Its 10% loss in year four neutralized the thrilling 20% gain in year five.

So What

Lower volatility portfolios not only increase returns but provide a smoother journey – a double benefit! Furthermore, with a longer investment period, we get a proportionately higher gain. Instead of the $1,624 volatility drag bonus the lower volatility portfolio gave us over five years, we would be seeing a far more significant gain of perhaps $100,000 over thirty years. The long-term investment prize will go to those who can maintain the proven lower volatility strategy even in the face of slightly underperforming in very strong markets, conquering FOMO (fear of missing out).

Thank you for investing with us.