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What investors often get wrong about risk

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It is always difficult to write an article in the finance space. Many of the key topics, like the benefits of staying invested or the power of compounding have been extensively covered, often restating what we already know. If you enjoy more nuanced pieces, you've likely come across an investment guru's take on what makes a good investment or how to spot a great company. These often come packaged with a few Buffett quotes and, more often than not some kind of underlying agenda.

I have one too; my wife and I were recently blessed with a son. Managing investments is a time-consuming job, but whatever work I do, I want it to leave behind valuable lessons, lessons that will hopefully give him the tools to build wealth and thrive in life.

So, what to write about?

In our world, you will often hear the saying “It’s about time in the markets rather than timing the markets.” I won't argue the point that timing the markets is wrong, but for now I want to shift the focus to the value of staying invested over time.

This brings me to a related idea that’s been on my mind for a while, one of those thoughts you just can’t shake: the difference between volatility and risk. It first came up in a discussion with Jonathan du Toit and has stuck with me ever since.

It’s not only a valuable way of thinking for investment managers, investors, and anyone navigating the markets, it’s also a powerful lesson for life in general. I believe that if you can distinguish between the two, you’ll not only be better positioned to build wealth, but you might also find more peace of mind along the way.

To start this discussion, it is important to clarify how we at OysterCatcher Investments view volatility. According to the Merriam-Webster dictionary, volatility is “a tendency to change quickly and unpredictably”. The market often sees this as the quantum of the price change of a share over a specific period. But we see volatility differently. To us, it represents a temporary change in price often triggered by overreactions from market participants in response to new information.

This kind of short-term price movement has become increasingly common. More retail traders now have access to leverage, and the explosion of information sharing through platforms like Facebook, X (formerly Twitter), and other peer-to-peer networks amplifies these reactions. As a result, volatility has become a regular feature of the market. Still, we see it as short-term in nature. For us, “short-term” can mean anything from a day to a few years, but crucially, it’s not permanent.

Take Grindrod as an example. Grindrod has many operations related to logistics. One of their divisions operates a commodities handling business. Occasionally, when commodity prices are extremely high, Grindrod can adjust its operations to capitalise on the trend. For instance, it might buy back rented storage space from a client whose commodity is out of favour and resell that space to a producer trying to increase exports of a high-demand commodity. This strategy gives all parties a short-term profit boost.

But we view such gains as temporary. Although they might make strong profits today that will help support the share prices in the short run, the underlying event eventually fades. Profits normalise, and the share price typically reverts to some form of fair value. An event like this could cause the share price to run up on good results and provide a selling opportunity.

That leads us to the other closely related cousin of volatility: risk.

According to the Merriam-Webster Dictionary, risk is defined as “the possibility of injury or loss.” While volatility is typically temporary, risk is more permanent. In an investment context, risk refers to events that can cause lasting damage to a business’s value, especially if the company doesn’t adapt to the changes.

A recent article highlighted how some cinema chains have quietly started closing locations. The initial risk came from streaming services like Netflix and Disney+, which made it easier and cheaper for people to enjoy content from home. Then COVID hit, forcing people to embrace streaming as their primary source of entertainment during lockdowns. Once audiences experienced how convenient it was, many never looked back.

To try and cover their fixed cost bases, the cinemas had to raise ticket prices, charging enough to make you cry through the movie for the wrong reasons. This made the cost benefit of consuming content through the streaming services even more attractive, which led to a smaller portion of the population now able to afford going to the cinema. This ultimately led to the closure of some cinemas, making it even more inconvenient for movie-goers. The downward spiral is an example of a risk. The cinema industry is at risk of disappearing permanently with the likes of Blockbuster, Blackberry, Kodak and MySpace.

Volatility is inevitable. Risk is manageable.

We believe that volatility is an inherent part of the markets. Prices will rise and fall, and from time to time, some companies will become obsolete. But over the long term, markets tend to grow. Entrepreneurs adapt, find opportunity in disruption, and evolve as the landscape changes.

As investment managers, our job is to manage risk. Every company carries some form of risk. MTN, for example, faces ongoing exposure to geopolitical and currency risks. A country like Nigeria could increase corporate taxes or experience a sharp currency depreciation overnight. Similarly, companies like Naspers and Prosus are vulnerable to regulatory shifts in China. Their largest asset, Tencent, could face restrictions on profitability just as China did to its private education sector a few years ago.

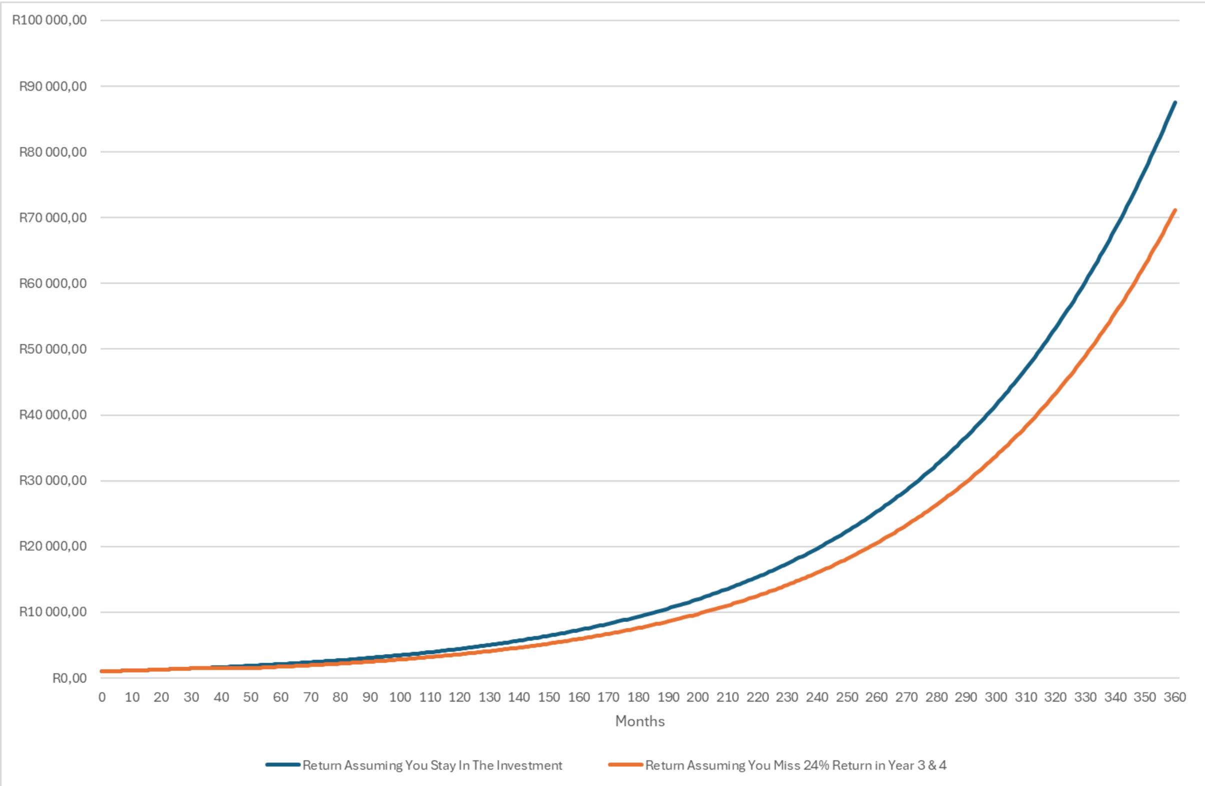
The key to managing risk lies in thoughtful position sizing. If a permanent loss occurs, the exposure should be small enough that it doesn’t cause lasting damage to the overall portfolio.

As an investor, it is important to know the difference between volatility and risk. It will allow you to understand what is happening in your portfolio, recognising that temporary volatility may lead to bad performance in the short term.

Take one of our investors, we’ll call him Bob. He found our fund through an online search in April 2023 and invested a sizeable amount, relative to the average net asset value for a South African individual. Six months later, the market had declined by about 5.7%. While our fund outperformed, it was still negative in absolute terms. Bob decided to withdraw his investment, citing that he couldn’t tolerate the volatility.

For full disclosure, I had personally highlighted the fund’s historical drawdowns which were sometimes more severe, though still outperforming the broader market before he invested. Fast forward to November 2024, the fund had risen by over 24% since Bob's exit, and he chose to reinvest.

The compounding cost of mistaking volatility for risk can be significant.



The chart above illustrates what Bob potentially lost. Suppose the fund delivered an average return of 15% per year, and Bob was fortunate enough to invest R1,000 right at the beginning. By the end of year 3, his investment would have grown to R1,564. However, Bob chose to exit the market for just over 17 months—missing out on a 24% return. For simplicity, let’s assume he earned 0% while out of the market. That short absence cost him R416 in immediate gains. But the real cost came from lost compounding. By the end of 30 years, that initial misstep had grown into a R17,240 difference. Mistakes, like investments, compound over time.

As every first-time parent knows, sleep quickly becomes a cherished commodity. And like markets, it can be volatile. But, as with most things in life, this phase is temporary. I’ve yet to meet an adult who wakes up at 1 a.m., plays with toy cars for an hour, sleeps for another hour, and repeats the cycle until it’s time for work.

If you focus too much on the volatility of sleep, you might miss the growth of your child. One will return with time the other will be gone forever.

Glacier Research would like to thank Wessel Joubert for contributing to this week's *Funds on Friday.*

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Wessel Joubert joined Oystercatcher Investments in 2019 and is an Investment Analyst. Oystercatcher Investments manage the Amplify SCI Equity Fund, and the Amplify SCI Managed Equity Retail Hedge Fund.

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