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The Impact of Volatility on Wealth

By Ian A. Post, CFA, CFP®

I am not a golfer (tennis is my game) but my roommate in college was the captain of the golf team. Over time, my head filled with various golf sayings. One of my favorites, "drive for show, putt for dough", always reminds me of the importance of focusing on what really matters. In investing, what ultimately matters is growth of wealth over time. But what measures really determine wealth creation? In golf terms, the "drive" measure is the average return while the "putt" measure is the compound return. Yes, the difference between these measures really matters.

The difference between compound returns and average returns is that compound returns consider ***how*** the returns were realized and, surprisingly, that impacts wealth over time. More volatile returns will result in less wealth over time and vice versa.

An example of how volatility impacts wealth can help drive home the point. On January 1st of Year 1, you invest $100 in each of two portfolios, DRV and PUTT. DRV is more volatile but also has a higher expected return. PUTT is less volatile but with less potential upside. After three years, you review the results of each of the portfolios at right.[1]

Portfolio	Year 1 Return	Year 2 Return	Year 3 Return	Average Return	Compound Return	Final Value
DRV	**35.0%**	-20.0%	**15.0%**	**10.0%**	7.5%	$ 124.20
PUTT	15.0%	**3.0%**	10.0%	9.3%	**9.2%**	**$ 130.30**

The table summarizes the results (the better result for each column is in bold). DRV delivered better returns in two out of the three years and a higher average return than PUTT. PUTT outperformed in just one year and delivered a lower average return that DRV. Yet by the measure that really matters to investors, PUTT was the superior portfolio. The $100 investment in PUTT grew 5% more than DRV (and provided a smoother ride along the way).

This is an example of what is called "volatility drain", an important consideration when investing in volatile assets (i.e. mostly everything other than bank accounts and CDs). When designing portfolios with the goal of increasing wealth over time (commensurate with an investor's risk tolerance), there are two parts of the equation to consider: One: include assets with positive expected returns and Two: combine assets in ways that reduce volatility.

The combined result of a well-designed portfolio is increased growth of wealth delivered more steadily over time. Speaking of time, I remember another saying from my friend's golf coach that he used when players complained about something not being fair, "If life was fair, I would have hair." Time has certainly brought that point home…

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[1] Investments and results are hypothetical and are for illustrative purposes only.