BLUE CAPITAL

VOLATILITY- THE ALCHEMY OF RISK

Low volatility can sometimes mean the calm before the storm, but even when it is the storm, volatility shouldn't be seen as a scary thing.

Regardless, it would be a mistake for investors to push volatility down their list of things to worry. Volatility is unique, and any investor who wants to thrive in the markets should understand this. Sometimes volatility can indicate danger while in the same breath, with just a shift in direction, it can be seen as powerful opportunities.

The most important thing when dealing with this phenomenon is that investor should not only be able to predict what to expect from the movements in volatility but also create plans so that they can react accordingly.

Is Volatility the same thing as risk?

One very recurring mistake made by investors is confusing volatility with risk. At its best, volatility can cause unwarranted stress and worry, while at its worse, volatility can result in huge financial losses. It is, therefore, important that investors can distinguish between the two.

Volatility simply describes the extent to which the value of stocks fluctuates. Stock prices rise and fall in volatile periods, while the performance of stocks is more fluid and more predictable in less volatile periods.

On the other hand, risk is the probability of selling at a loss, and the primary factor that distinguishes them is the time horizon.

Simplifying volatility as "risk" is an error in judgement that is often a result of overly watching your investment portfolio. This reaction is completely understandable, given that the stock market is very risky in the short term, and one would agree how gut-churning it can be, to watch your life savings jump up and down all day.

What is volatility, and how does it affect you?
In the financial market, volatility is defined as the rate at which the price of an asset increases or decreases, looking at a specific set of returns. It is often measured using the standard deviation of annual returns over a period of time.
Essentially, volatility is a measure of the risks associated with specific investment options and is used to measure fluctuations in returns when pricing assets. In other words, when volatility is high, trading risks are also higher while when volatility is low, trading risks are lower. The use of volatility in the pricing of financial assets can help estimate the likely hood of fluctuations a short term.
If the price of an asset changes quickly in a short period of time, it is considered very volatile. An asset whose price moves more slowly over a longer period of time is regarded as one with low volatility.

Volatility simply describes the extent to which the value of stocks fluctuates

Therefore, it is more effective to minimize volatility for a particular level of returns or to maximize returns for a particular level of volatility. According to this definition, volatility is a measure of the change in results which is generally expressed as standard deviation from an average level. However, volatility can mislead investors.

Types of volatility
Volatility is one of the factors that investors analyze in the process of making trading decisions. There are two fundamental approaches to volatility with their pros and cons:
Implied volatility:
The term implied volatility discloses the estimated volatility of assets. Implied volatility reflects how the market sees where volatility can be in the future, but cannot predict in which direction the price of assets will move. Overall, the implied volatility of an asset in a bear market increases, as most investors assume that its price will continue to fall over time. It falls in a bull market as traders believe the price will increase over time. This is due to the general belief that bear markets are inherently more risky than bull markets. Implied volatility is one of the ways traders estimate future price movements for an asset based on various forecasting factors.

Realised / historical volatility:

Realized volatility, which is often referred to as historical volatility, is a way to statistically measure how the returns of specific assets or market indexes are distributed over a certain period of time during analysis. Typically, historical volatility is measured by determining the average deviation of a financial instrument from its average price over a period of time. Standard deviation is generally the most common measure of historical volatility, although there are other methods through which you can use to calculate this metric. Risky security has a high historical volatility value, although it is not necessarily a negative factor in certain types of transactions, as upside and downside conditions can be risky. In relation to these two parameters, historical volatility (retrospective) serves as a reference, while implicit volatility defines the relative values of asset prices.

If the two measures have similar values, it is assumed that an asset has a fair price based on historical standards. For this reason, traders look for deviations from this balance to determine if the assets are overvalued or undervalued.

The standard deviation model for assessing financial volatility

Standard deviation is a measure used to statistically establish the degree of deviation or variance around the average price of assets. It is an appropriate method for measuring market volatility.

In general, the deviation is the difference between the average value of an asset and its real value—the greater the deviation or variance, the greater the standard deviation. The lower the variation, the lower the standard deviation. Analysts often use the standard deviation to measure the expected risk and determine the significance of a price movement.

Implied volatility is one of the ways traders estimate future

Hedging

The volatility risk of an equity portfolio can be hedged by a number of financial instruments which include options and indexes. Options are the right, but not the obligation, to buy or sell a security at a specific price on or before a specific date. The price of an option is based on the implied volatility that supports the volatility risk hedging process. The risk of implied volatility is called Vega or security. To hedge and invest a stock portfolio, you can use a put option. This gives the investor the right to sell a security or index and therefore protects him from unfavourable movements in the stock. It is essential to understand the risk of volatility that prevails in all portfolios.

The way an investor manages volatility is primarily dependent on the immediacy of their objectives. Short-term investors may see volatility management techniques as beneficial.
While long-term investors, may how volatile markets can create significant opportunities for them to realize higher yields.

How market volatility affects a traders sentiment
The consideration of market sentiment is a crucial part of analyzing financial data. The prices of assets traded on the financial markets will generally rise and fall daily, a natural effect of the unstable behaviour of financial markets.
Despite these price movements, hundreds of millions of investors around the world continue to risk their money on the financial market and hope to make a profit in the future. Financial market volatility is of interest to investors, as high volatility often leads to massive profits or substantial losses at the expense of increased uncertainty.
When volatility is extremely high, investors can halt investments for fear of losing their capital. Others make risky trades in the hope of higher returns.

Risk alone does not guarantee results- it only affects the chances of winning. The global volatility trade in all its forms is like a barrel of nitroglycerin in the market portfolio. It can either explode or not. We know that it has the potential to spark a little match stick into a massive explosion. So as an investor, you must always be careful of your investment decisions.

The benefits of volatility.
Volatility is a popularly misunderstood concept. Volatility can be a powerful force for positivity, as these wild changes work both ways. Investments in the stock market require a long-term perspective. History has proven how profitable the financial markets can be for your investments over periods of 10 years or more.

What matters is that it almost always outperforms alternative investments like cash. Although volatility can be stressful, experience shows that it is better to remain invested in difficult times.