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Expert panel: Defining risk depends on investing horizon

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What's the right definition of risk in financial markets?

Finding the answer to this question has become even more important because the number of retail traders is at a record high. Over the past 10 years, between 10 per cent and 15 per cent of all U.S. trades have come from retail accounts. So far in 2023, that figure stands at about 25 per cent.

Institutional investors may not understand the risks to which they're exposed, either. As Howard Marks, U.S. investor and writer, said: "Much of the risk in investing comes not from the companies, institutions and securities involved. It comes from the behaviour of investors."

To answer the question, it's important to first choose a definition of risk. Finance academics define it as volatility, while value investors say risk is the probability that adverse outcomes in the future will permanently impair a business' cash-flow potential, leading to the permanent impairment of capital.

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Which is the right definition? It all depends on the investment horizon. Different horizon investors assess risk differently. If the most important outcome is maximizing terminal wealth — and it's difficult to argue it isn't — then the latter definition is the one to go with.

While economist Harry Markowitz defined risk as the standard deviation of returns (volatility), economist William Sharpe argued that, in a well-diversified portfolio, the only risk that matters is beta risk. Both economists won Nobel prizes in economics, have had lasting impacts on academia and their work gave rise to the notion that short-term fluctuations in the value of a portfolio are important and the only risk that matters, which is often espoused by financial analysts and academics..

So how much should institutional investors worry about this short-term volatility? Not much.

As Charles Munger, vice-chairman of Berkshire Hathaway Inc., said: "If you're investing for 40 years in some pension fund, what difference does it make if the path from start to finish is a little bumpier or a little different than everybody else's so long as it's all going to work out well in the end? So what if there is a little extra volatility?"

Recent research by Javier Estrada, professor of finance at the IESE Business School in Spain, bears this out. He concluded: "Investors should learn about the detrimental impact of reacting to short-term volatility and focus on the endgame instead."

The research found that, in the U.S., the mean terminal wealth of investing in stocks over a 10-, 20- and 30-year period is 59 per cent, 146 per cent and 299 per cent, respectively, higher than investing in bonds. In Canada, the corresponding figures are 41 per cent, 88 per cent and 131 per cent. For world markets, they're 49 per cent, 116 per cent and 231 per cent.

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The volatility of terminal wealth across all holding periods has been found to be higher for stocks than bonds in every market examined. Thus, stocks are riskier when risk is measured by volatility. But, interestingly enough, the higher volatility of terminal wealth from stocks is mostly on the upside. Stocks have both higher upside and more limited downside than bonds.

Why, then, are stocks viewed as riskier than bonds? It may be the wide acceptance of volatility as a measure of risk at universities and academia's influence on the chartered financial analyst program. There could also be institutional, as well as behavioural, reasons.

In a perfect world, both the investor and mutual fund manager will have long-term horizons and volatility would play no important role. But what if the investor has a short-term horizon and detests (or panics in the face of) short-term volatility?

In this case, the mutual fund manager will have to consider short-term volatility if they don't want to lose funds under management and possibly their job. They'll have to abide with the desires of the investors and focus on short-term volatility, thus contributing to the focus of the mutual fund industry and financial analysts on the short term.

Perhaps most of us are speculators — like those seeking to make a quick profit from short-term stock price movements — and not investors taking a long-term approach to managing our portfolios. Last year, for example, 60 per cent of Robinhood Markets Inc. revenues came from trading of options by retail investors.

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