Risk and Volatility – Aren't They the Same?

Introduction

Read a lot of stock market reports, especially quantitative analyses, and you may notice many on Wall St. equate volatility with risk and that is not only a little wrong, it is sometimes catastrophically wrong. We tease apart these related concepts to see where the traps lay and how the pros at Life Unlocked sidestep them most of the time.

Risk or Volatility?

> **Volatility** – the degree to which the price of any stock or bond goes up and down each trading day. The more extreme and/or unpredictable the movements, the more volatile the stock or bond – that's it.
>
> **Risk** – the degree to which the company's future results are unpredictably very positive or negative. That cloudy future is a function of many diverse factors both inside and outside the company, some of which we list below.

It's easy to see how these ideas can seem the same due to their degree of unpredictability and the ways in which they intersect, but they are also very different:

1. Risk comes almost exclusively from business results and the risk the company can earn enough future profits to justify today's stock price, which includes but is not limited to:
    a. The state of economy
    b. Ability to sustain or grow profits
    c. Competitive risks
    d. Business execution risks
    e. Intellectual property value (patents and proprietary processes)
2. Volatility is influenced by risk while also directly reacting to:
    a. How many shares can be easily purchased (the "float")
    b. How traders view demand and supply
    c. Investors not understanding the information the company provides (a big source)
    d. Future speculation about impactful events like acquisitions, new products or a "short squeeze" (the biggest source).

In other words, Risk primarily relates to events that are part of the company whereas volatility relates to how the company's stocks and bonds move. Each of these can move for very different reasons, as noted above.

Example 1 - GameStop

There exists a group of stocks called "meme" stocks because they trade in almost no relation to their business results. Among these stocks, GamesStop (GME), a video game retailer, ranks as the king of volatility disconnected to company level risks.

You may remember during COVID that GameStop experienced both negative earnings and a huge run up in its stock price to nearly $90 per share (adjusted for today). In this mess, a hedge fund had intentionally exposed itself by selling

so much more GME stock than it controlled, leading to an epic “short squeeze” that basically put the hedge fund out of business.

The mechanics of this are not as important as seeing the stock price volatility where GME shares traded anywhere from $86 per share to $20 within 12 months for a company with a steadily declining business and few future prospects (most video game players download games directly rather than go to a retail store to buy a disk.)

We witnessed the GME stock price moving with tremendous volatility, but their reported results in no way supported these moves. In May 2024, GameStop made fresh headlines when its stock price shot up to almost $50 from $11 per share on the report that “Roaring Kitty” posted a video.

OK, a stock moving because a Reddit investor named “Roaring Kitty” posts a video is a perfect example of volatility disconnected to risk. GME’s risk has not meaningfully changed this year – they are in a slow inevitable decline just like Blockbuster Video. GameStop’s June 2024 stock price does not reflect this inevitable decline which should drive the stock price far lower, but rather speculative volatility related to investors not understanding that GME has almost no future as a video game retailer. GameStop may have some other value, but that is so speculative that it’s hard to give it any value at all. Meanwhile, this company holds a bunch of mall leases plus video game disks which is more likely a negative than a positive given today’s economy.

GameStop is a perfect example of volatility with zero attraction for us.

Example 2 – NVIDIA

Today's leading Artificial Intelligence chipmaker had been focused on graphics chips for smoother video execution on our computers and video game rigs for nearly all of its existence. Then, in early 2023, NVIDIA's line of artificial intelligence chips took off with the November 2022 introduction of Chat GPT. Since that earthshaking moment, NVIDIA's stock price has outperformed almost everything, more than doubling this year so far.

Until 2024, we can see NVIDIA's stock price trading in tight relation to its risk. The market for graphic acceleration chips was steady, requiring regular improvements to keep up with increasingly sophisticated game demands for years and years. The successful introduction of large language AI models suddenly changed demand for NVIDIA chips and in June 2024, NVIDIA trades at about 68 times 2024 profits, or about 45 times 2025 projected profits – that's a lot of risk and volatility together when the average mature company trades closer to 18 times.

For us, the risk is how the future for AI chips will unfold and how NVIDIA will profit from it. If they can continue their current growth rate for the next 3 years and the stock price remains the same, NVIDIA will be trading at about a more normal 20 times 2027 earnings. Of course, the stock price will almost certainly go higher IF the company's growth rate holds, which represents the volatility surrounding NVIDIA's stock price.

Here's the company risk: competition, demand for more chips and the ability to price for good profits.

Here's the volatility: the stock price will continue to trade at very high multiples of today's profits by assuming the same growth rate in demand and profits for years to come and that has to be wrong. Wrong to which side is the big issue and we cannot tell today whether NVIDIA is more likely to outperform or underperform these assumptions and the accompanying volatility – that's quite the gamble given how widely these results can vary.

We see NVIDIA having both high speculative volatility and risk, as represented by its nosebleed stock price. Will it prove to be a wise investment today? We cannot tell and the imbedded speculative risk makes it unattractive when risk containment is an important part of our investment philosophy. NVIDIA is, however, a great example when both high risk and high speculation hit a stock, sending it so high it becomes legendary in its prime.

Example 3 - Eversource

An electrical utility based in the Northeastern US that competes with other utilities serving entire communities and expanding businesses. In June 2024, many electrical utilities have traded higher based on projected needs for artificial intelligence data centers. By June 2024, some utilities saw double digit stock price increases with accompanying earnings growth. Eversource (ES) sat out most of this increase posting a lower stock price from January 2nd close. Let's look at ES against several top competitors – Sempra (SRE), NextEra Energy (NEE) and Duke Energy (DUK):

	ES	SRE	NEE	DUK
YTD Price Performance	-4.42%	0.94%	18.75%	5.12%
1Y Price Performance	-16.16%	2.14%	-2.62%	11.46%
3 Year Price Performance	-29.02%	8.00%	-1.88%	0.29%

Eversource doesn't look very dynamic and there's not a lot of volatility in the stock price either as measured by a concept called Beta[1]:

	ES	SRE	NEE	DUK
24M Beta	0.66	0.67	0.71	0.53
60M Beta	0.61	0.75	0.55	0.45

1- Beta measures stock price volatility over both 24 and 60 months versus the overall stock market. Average volatility is 1. Anything less than 1 is less volatile than the market and all of these have low volatility.

And each company has to deal with a different amount of debt, where too much can hurt growth:

	ES	SRE	NEE	DUK
Debt/Free Cash Flow	-13.27	-13.11	-6.08	-39.18
Long Term Debt/Total Capital	58.80%	44.55%	47.28%	57.08%

We see most electrical utilities trade on their perceived risks and ability to grow. Those with more capital to invest with attractive opportunities can trade higher with a little more volatility than the average utility. When we look at each of these company's ability to tap new projects, we see that both SRE and NEE have the least debt burden and easiest path to growth.

Eversource and Duke each may have to raise new capital to grow or just stay steady and boring. As we look at each company, we do not see why ES's stock price has fallen this year when it has attractive opportunities whereas NextEra seems to run a bit ahead of itself and has more speculation in its June 2024 value given the steeper rise in its price.

Based on the above, we would see SRE as the most attractive and ES as trading mostly on its current risk with little value given to its future opportunities, making it our second choice in this group today. We see NextEra has having more volatility after a big price run up (it also has the least debt and greatest ability to grow) while Duke looks like it could fall due to high debt payments before rising again.

Conclusions

1- When a business is purely speculative, like a meme stock, it is inappropriate for us because we cannot remotely connect its risk to its stock price – craziness;
2- We should expect riskier businesses like NVIDIA to experience more volatile price movements, but not all those movements are related to risk when so many people are speculating about how the future will unfold; and
3- Less risky investments are far easier to assess when they are not volatile, like electrical utilities.

Now, it's reasonable to ask, "Why not take as little risk as possible?" which immediately takes you to FDIC-insured savings accounts and US government bonds. When we take the least risk, we tend to underperform the stock market because we have to take enough risk to keep up with the overall economy.

In other words, if our total economy is also a reflection of total risks, then only taking the least risk has to give us lower than average returns over time in a growing economy (we get left behind.) Risk is not our enemy so much as volatility that is disconnected to the business's actual risks and that is worth all our attention when considering any investment:

1- Prioritizing risk over volatility.
   a. Risk for whether we'd like to invest; and
   b. Volatility for finding attractive points to buy the investment.
2- Confusing the two can lead to buying GameStop when we'd really rather own almost anything else.
3- Ignoring either risk or volatility will also lead to bad outcomes:
   a. You might think NVIDIA's stock price is just the risk associated with high execution risk, but there's irrational enthusiasm in there, too and that's a negative.
4- Finding the right tradeoffs to keep us in touch with the overall economy requires discipline in the right sequence with the right balance.

When we deploy risk and volatility correctly, we become better investors. While outcomes are never guaranteed, shifting the field in our favor is always a good thing. We'll take the good things.