Measuring investment risk

Common barometers that help define volatility

Risk measures can be just as important as return measures. These are some potential metrics.

If you are researching new investment avenues, chances are "evaluating risk" could be an important part of your checklist. Financial experts have developed many methods for measuring risk, but beta and standard deviation are two common options.

Beta calculates how much (or how little) an investment's price varies relative to a specific benchmark. For stocks, the S&P 500 is often used.[1] For bonds, it might be the Bloomberg Barclays U.S. Aggregate Bond Index.[2] The mechanics of beta are fairly simple: The benchmark is assigned a risk rating of 1.0. So, if a stock has a beta of 1.1, for example, it has been 10% more volatile than the general market. If the market benchmark had a return of 10% over a certain period of time, an investment with a beta of 1.1 would have returned 11% during that same span.

Similarly, if the market benchmark declines 10%, the investment would have dropped 11% over that same period of time. Because it is calculated in relation to a benchmark, beta may provide a more accurate risk reading for specific asset classes.

Standard deviation measures how much an investment's return fluctuates from its own longer-term average. Higher standard deviation typically indicates greater volatility—but does not necessarily indicate a greater risk of loss. How so?

While standard deviation quantifies the variance of returns, it does not differentiate between gains and losses. Consistency of returns may also be considered. For example, if an investment declined 2% every month for a specified period of time, it would earn a standard deviation of zero. Alternatively, an investment that earned 8% one month and 12% the next would have a much higher standard deviation, but for suitable investors, this may be the preferable investment. The lesson to be learned? Greater volatility in and of itself may not necessarily be a bad thing.

One of the key strengths of standard deviation and the reason it is a commonly used risk barometer is its universal applicability across asset classes and types of securities.

While understanding the role that risk plays in your portfolio is important, no amount of knowledge can eliminate risk entirely. That's why it is important to manage risk through diversification and other strategies.[3]

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[1] Investing in stocks involves risks, including loss of principal. Standard and Poor's Composite Index of 500 Stocks (the S&P 500) is an unmanaged index that is generally considered representative of the U.S. stock market. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.
[2] Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. The Barclays U.S. Aggregate Bond Index is considered representative of most U.S. traded investment grade bonds.
[3] There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against a loss in a declining financial market.

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