

# Measuring investment risk

## Common barometers for **defining volatility**



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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.<sup>1</sup> For bonds, it might be the Barclays U.S. Aggregate Bond Index.<sup>2</sup> 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 has a return of 10%, an investment with a beta of 1.1 would be expected to return 11%.

Similarly, if the market declines 10%, the investment would be expected to drop by 11%. Since 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 is what matters most. For example, if an investment declined 2% every month for a specified period of time, it would earn a seemingly positive standard deviation of zero. Alternatively, an investment that earned 8% one month and 12% the next would have a much higher standard deviation, but by most accounts it would 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 the most 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.<sup>3</sup> Contact your financial professional to learn more about managing risk in your portfolio.

- <sup>1</sup> Investing in stocks involves risks, including loss of principal. Standard & 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.
- <sup>2</sup> 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.
- <sup>3</sup> There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not ensure against market risk.

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