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How to Stay Ahead of Volatile Share Prices

Description

This year looks set to be relatively uncertain. Already, there are signs that the global economic outlook could become increasingly unclear. For example, in Europe the issue of Brexit is likely to become increasingly prominent as negotiations commence. In the US, President Trump is likely to deliver major change to the economy. And in China, the world's second-largest economy is continuing on a transitional path towards a more consumer-focused economy. As such, setting your portfolio up to cope with higher than average volatility could be a sound move.

Beta

One way of reducing the potential for wild swings in share prices is to buy stocks with low betas. A company's beta essentially tells an investor how its share price is expected to move in future, versus the wider index. A company with a beta of 1, for example, is expected to move in line with the wider market. A stock with a beta of 0.5 should move up or down by 0.5% for every 1% up or downwards movement in the wider index. A beta of 2 means double the price movement of the index.

Using beta to build a lower-volatility portfolio could be a sensible move. Although it does not guarantee a lack of volatility since the future does not perfectly replicate the past, it is useful in gaining an idea of how volatile a particular share price could be in future.

Business model

Of course, an obvious way to assess whether a company's share price will be volatile is to assess its business model. Cyclical companies tend to have the most volatile share prices. Their sales and profitability are highly dependent upon the economic outlook. In contrast, stocks which are more defensive are less positively correlated to the performance of the wider economy. Their financial performance may be less susceptible to a recession, but equally it may benefit less if there is an economic boom.

Examples of less volatile sectors could be healthcare, utilities and tobacco. Cyclical sectors which may be more volatile include travel & leisure, discretionary consumer goods and commodity stocks.

However, this is a rather generalised list and the reality is that a company's own, unique business model dictates its share price volatility. Finding stocks which have a wide range of products and which operate in a range of geographies could be a sound means of reducing overall volatility. Should there be an issue with a specific product or a slowdown in one region of the globe, a more diversified business should cope better than a more concentrated peer.

Outlook

The global economic outlook for 2017 is exceptionally unclear. Therefore, it seems likely that share prices will remain volatile over the coming months. Diversifying between a number of stocks operating in different sectors while also focusing on a company's business model and beta could be a logical means of reducing your own portfolio volatility. Doing so may not drastically improve your overall returns in the long run, but it could make 2017 a more settled, consistent and worry-free year than it may prove to be for most investors.

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