# RiskRatings™

Your guide to profiting from share price volatility.

Stockopedia

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## Your guide to profiting from share price volatility.

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# Introduction

The **RiskRatings** are Stockopedia's classification of the market volatility of every company's share price. We have designed the RiskRatings to be both a useful predictive measure of future volatility, but also an easy to use measure for accessing the "low volatility anomaly" - the unusual fact in equities, that lower volatility securities tend to outperform high volatility securities over the long term.

The five classifications (from least to most volatile) are **Conservative**, **Balanced**, **Adventurous**, **Speculative** and **Highly Speculative**. At any time 10% of the market will be classified as Conservative, 15% Balanced, 20% Adventurous, 25% Speculative and 30% Highly Speculative.

In general, larger, more predictable and more profitable companies (such as Microsoft or Unilever) tend to be classified as Conservative, while younger, news driven, early revenue companies (such as Snap Inc or Sirius Minerals) will be classified as Speculative.

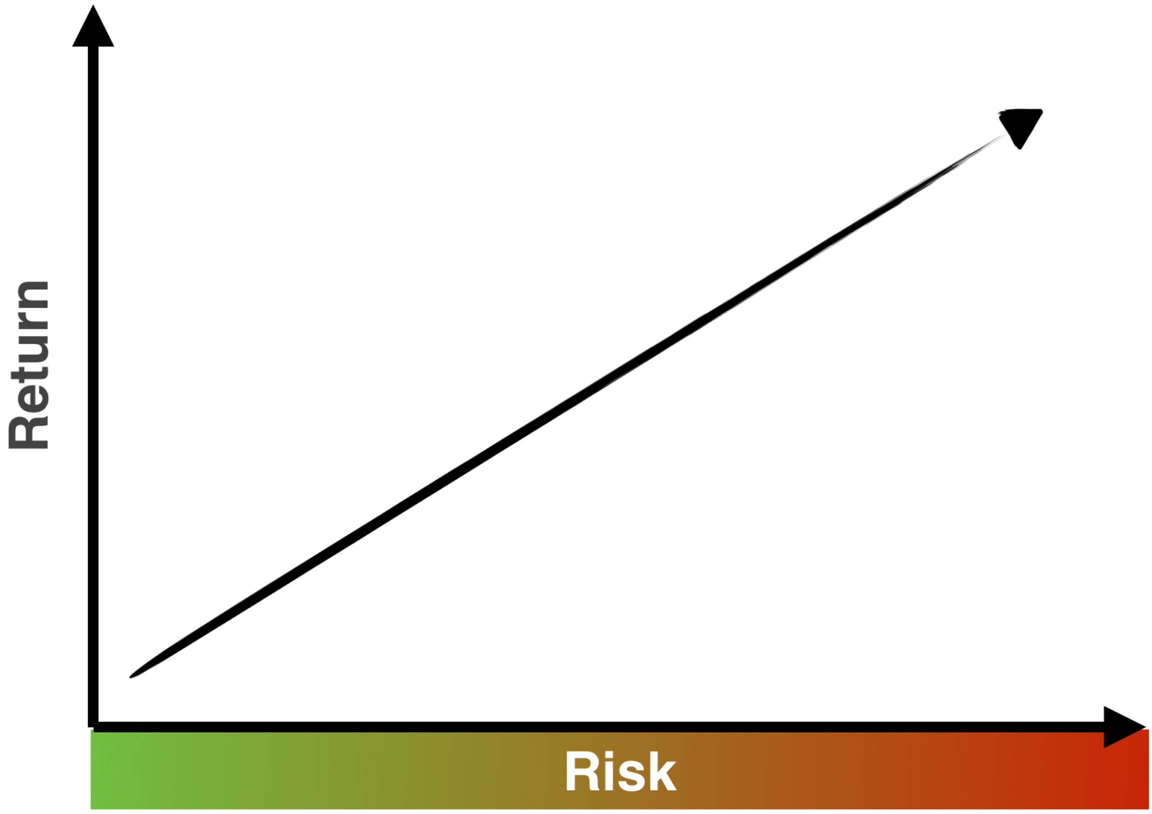

Volatility is the most common measure of risk used in quantitative finance to assess **risk adjusted returns**. The use of volatility as "risk" is somewhat controversial, and criticised by many value investors. The common complaint is that *“risk is not volatility, it is the likelihood of capital loss”*.

But modern portfolio theory, and most private investors, more broadly define Risk as the possibility of **upside gain** as well as **downside loss**. While value investors have struggled to quantify the likelihood of capital loss, Quantitative Investors have proven that price volatility is one of the best predictors of future upside and downside financial risk.

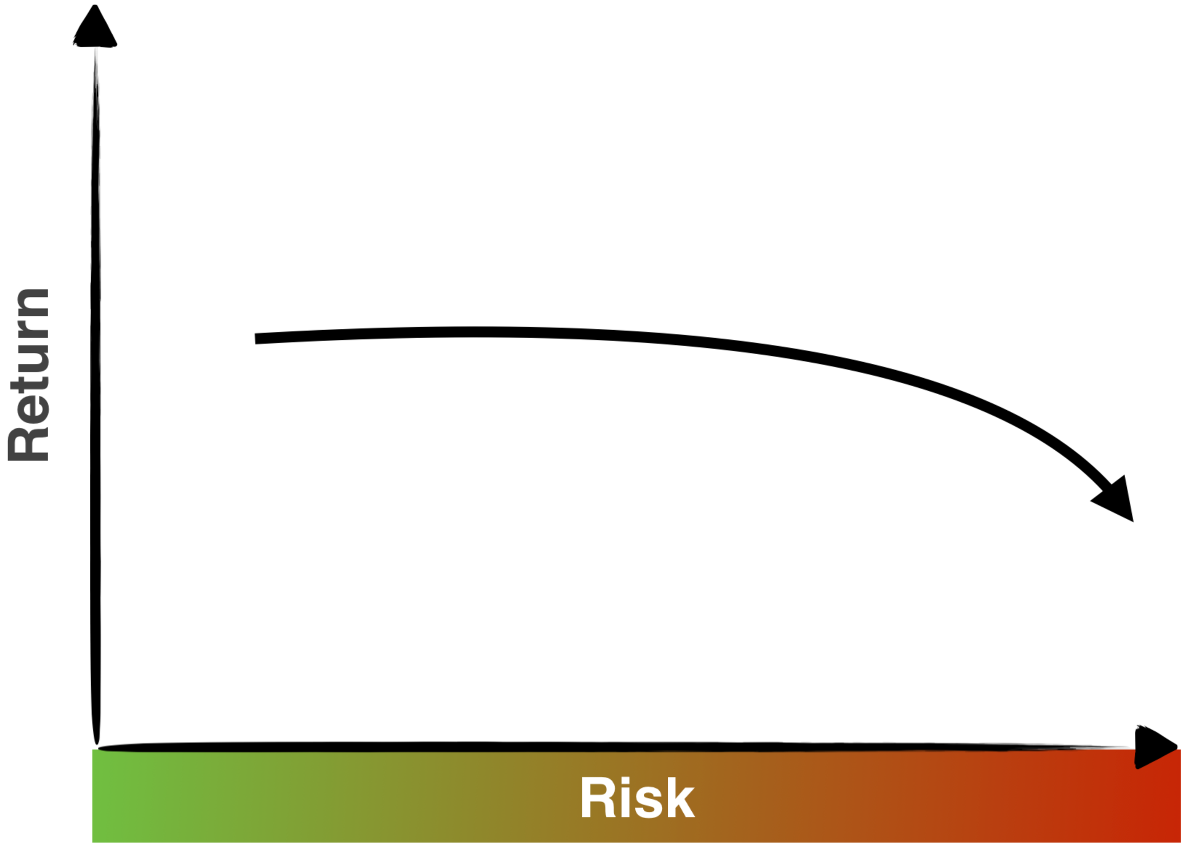
> While the RiskRating is the essential rule of thumb for this purpose, we do recommend using the full suite of financial indicators available on Stockopedia to measure standard financial risks - including Bankruptcy Risk, Earnings Manipulation Risk and other Quality factors.

## Risk and Return - theory vs practice

Most investors believe in the theory that risk and return are joined at the hip. The idea persists that to achieve higher returns you have to take on more risk.




While this may be true across different asset classes (e.g. high volatility stocks outperform low volatility cash) this theory appears to fall apart within stocks. Research studies by famous academics and practitioners including Haugen & Baker, Blitz & van Vliet and Frazzini & Pederson have proven that historically low volatility (and low beta) shares outperform high volatility shares over the long run (on a risk adjusted basis).




The reason for this ‘anomaly’ is due to a few primary factors. Firstly, investors are often averse to borrowing money to invest in low volatility equities; Secondly, the investment process at institutions is often biased towards risk-seeking by fund managers who seek to improve their bonuses in the short term; Thirdly, private investors often aim for Lottery type rewards from high risk investments. All these factors, and more, ensure that higher risk assets are often systematically over-priced, reducing their eventual returns and inverting the risk-return relationship.

Whatever the reason, the fact remains that so many private investors chase high risk / speculative shares at precisely the wrong moment. As we’ll see, there are good times and areas of the market to invest in high risk shares, but over the long term, and in general, a conservative bias in the stock market does bring additional rewards.

For those inclined to investigate the academic research we recommend the research papers listed in the conclusion of this guide.