INVESTMENT FUNDAMENTALS

What is Beta?

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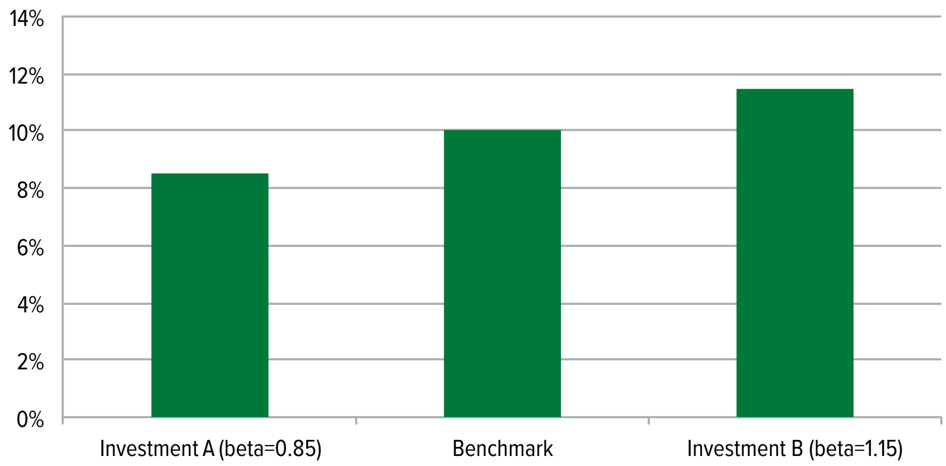
Snapshot

- Beta is the measurement of an asset's relative volatility as compared to a benchmark.
- Understanding an investment's level of sensitivity can help investors understand how their portfolios are likely to respond in rising or falling markets.
- This information can aid investors in selecting an investment that aligns with their financial goals and risk tolerances.

Beta is a measurement of relative volatility. This implies that the beta of an investment indicates how sensitive its price movement is, compared to the price movement of a given benchmark. As the baseline measurement of volatility, the benchmark is represented by a beta of 1.00. An investment with a beta of 1.00 would, therefore, be expected to move up or down by the same percentage as the movement of the benchmark. A 1% gain in the benchmark would be matched by a 1% gain in the investment. Similarly, an investment with a beta of less than 1.00 would be expected to move up or down by less than the percentage movement of the associated benchmark. Exhibit 1 shows a hypothetical example of anticipated performance for two investments, with different beta sensitivities as compared to a benchmark return of 10% for a given period.

Exhibit 1: Performance of Differing Beta Sensitivities



For Investment A, a beta of 0.85 indicates less sensitivity relative to the movements of the benchmark. If the benchmark returns 10% in this example, Investment A would be predicted to return 8.5%. Likewise, the higher beta sensitivity of Investment B would imply an expected return of 11.5%.

What Does This Mean for Investors?

The different levels of sensitivity for various investments can be attributed to a number of aspects. For example, a high-beta stock may show increased sensitivity to the price movements of a benchmark simply due to the type of industry in which the company has its business interest. Some industries, such as biotechnology, are viewed as high-growth areas, where outcomes are less predictable and are treated as riskier than the overall market. Reduced sensitivity (lower beta) may occur in a more conservative industry (i.e., utilities), where the variability around metrics, such as a company's earnings, is less volatile. For mutual funds, the investment strategy typically dictates the level of aggressiveness of the offering and, therefore, the beta.

Given this, when selecting an investment, investors should do more than pick an investment based on its past performance at a point in time. As indicated, the return patterns across assets can take different paths towards achieving their results. Even when comparing two assets that generated similar performance over a period of time, it is useful to understand how the assets achieved their results. One asset may have experienced a more volatile (or less volatile) pattern of returns in generating its result, as compared to another. While beta is not a metric to be used in isolation when making an investment decision, it is worthy of consideration, along with further analysis, when seeking an investment that aligns with an investor's temperament for risk (or volatility). It is not uncommon for a conservative investor to consider a low-beta investment, with a willingness to sacrifice some upside, in exchange for less downside participation during periods of decline. Conversely, more aggressive investors may seek a level of volatility that is higher than the broad market in an effort to generate investment returns that are greater than those generated by the benchmark.

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