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CAPITAL MANAGEMENT

Why low volatility is not the same as low risk

By Craig Racine – Managing Director & CIO, Gyrostat Capital Management

Some of the worst-performing portfolios in history appeared calm right up until they failed.

Low volatility is comforting. It signals control, stability and professionalism. For advisers and investors alike, smooth returns feel synonymous with safety. Yet experience suggests the opposite can often be true. Portfolios that appear least volatile are not necessarily those that carry the least risk.

In many cases, they are simply the most fragile.

Why volatility became a proxy for risk

Volatility is one of the most widely used measures in finance. It is observable, comparable and mathematically tractable. Risk models, optimisation frameworks and benchmarks all rely on it in some form.

This reliance is understandable. Volatility provides a common language for discussing uncertainty. It allows portfolios to be compared, constraints to be set, and outcomes to be explained.

Over time, however, convenience has quietly turned into substitution. Volatility has come to represent risk itself, rather than one dimension of it.

The result is a subtle but important shift: portfolios are increasingly designed to minimise visible movement, rather than to manage the consequences of stress.

What volatility does not capture

Volatility describes how prices move. It does not explain why they move, nor what happens when markets stop behaving normally.

Crucially, volatility does not capture:

- the depth of potential drawdowns,
- the timing of losses,
- liquidity under stress,
- correlation breakdowns,
- or the behavioural responses those conditions provoke.

A portfolio can display low volatility for extended periods while accumulating significant hidden risk. Stability in returns can reflect genuine resilience — or it can reflect risk that has been deferred, compressed or obscured.

The difference is rarely obvious until it matters.

The danger of smooth portfolios

Smooth portfolios are appealing. They tend to:

- reduce short-term discomfort,
- simplify client conversations,
- and create confidence during benign markets.

But smoothness often comes at a cost.

Portfolios engineered to suppress volatility frequently rely on structural features that only function under stable conditions. These may include implicit leverage, reliance on continuous liquidity, or exposures that benefit from calm markets but suffer disproportionately when conditions change.

When stress arrives, these portfolios can fail suddenly and non-linearly. Losses tend to be rapid, correlations converge, and exit paths narrow.

What appeared safe was simply untested.

Why this matters most for retirees

For retirees and investors approaching retirement, the distinction between volatility and risk is critical.

Volatility is uncomfortable, but recoverable. Risk, in retirement, is the inability to recover.

Smooth returns often encourage higher allocations, delayed protection and a belief that stability will persist. When disruption occurs, losses are often larger and more rapid than expected. Income streams are interrupted, behaviour deteriorates, and the time available for recovery is limited.

This is the practical reality of sequencing risk. Early losses not only reduce portfolio values; they also permanently alter income sustainability and longevity planning.

A portfolio that appears stable can therefore be more dangerous than one that is openly volatile but structurally resilient.

Asymmetry and the importance of downside control

True risk management is less concerned with the frequency of small movements and more concerned with the severity of adverse outcomes.

Downside asymmetry matters. A portfolio that avoids large losses does not need extraordinary upside to compound effectively. Conversely, a portfolio that suffers deep drawdowns must generate exceptional future returns simply to recover.

This is why downside control dominates long-term outcomes. The shape of losses, not their day-to-day variability, determines whether portfolios remain functional through full market cycles.

Volatility may fluctuate—damage compounds.

Measuring what actually matters

If volatility is an incomplete proxy for risk, what should advisers and investors focus on instead?

More useful questions include:

- How large are losses during stressed periods?
- How quickly does the portfolio recover?
- Does the portfolio remain liquid when markets are not?
- Can income be maintained during drawdowns?

These measures are less elegant than volatility statistics, but they are more relevant to real-world outcomes — particularly where capital preservation and income continuity matter.

Risk is best understood through consequences, not comfort.

From smoothness to resilience

Low volatility feels reassuring. It is easy to explain and pleasant to experience. But reassurance is not protection.

Portfolios designed to perform only when markets are calm tend to fail precisely when resilience is needed. Protection that appears only after volatility rises is usually protection that arrives too late.

True risk management accepts that volatility is inevitable. The task is not to eliminate it, but to ensure portfolios remain functional when it arrives.

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