# MARKET COMMENTARY

## EQUITY ANALYSIS

### THE VOLATILITY TAX: A HIDDEN THREAT TO YOUR WEALTH

Let's begin with some simple math. If you invest $100,000 and lose 10% in the first year, you're down to $90,000. If you then gain 10% in year two, you don't break even. You end up with $99,000. That's a net loss of $1,000 — despite an average return of zero percent.

How is this possible?

It's because averages lie. What matters in the real world is not average return but compound return. The number that shows up on your statement at the end.

Now consider a more extreme case. You lose 50% in year one, then gain 50% in year two. Average return? Again, zero. But your ending wealth is just $75,000. That's a devastating loss. The actual return over those two years is -13.5% per year.

These illustrative examples reflect the way volatility may chip away at real wealth.

Although technically not a tax, at Washington Crossing Advisors, we call this effect the volatility tax. And like any tax, it takes your money — quietly and persistently.

## WHAT'S REALLY GOING ON?

Here's the mechanism: when returns are volatile—when they bounce up and down—wealth erodes. Mathematically, your compound return suffers a penalty equal to roughly half the variance of returns. This is not an accident. It's arithmetic. And if you want the actual formula for annualized returns over time, here you go:

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**Return Math**

$\mu_g = \mu_a - \frac{1}{2}\sigma^2$

$\mu_g$ = **Geometric Return (Approximate)**

$\mu_a$ = **Simple Arithmetic Return**

$\sigma$ = **Volatility of Simple Arithmetic Returns**

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Regardless of the formula, what you need to know is that the more violent the swings, the greater the "volatility tax" to portfolio returns and the bigger the hit to wealth over time.

Many people misunderstand this, and maybe with good reason. Financial theory suggests that volatility and risk are things we must tolerate as the price of big returns. But what they fail to see is that unchecked volatility doesn't just increase risk — it also imparts a substantial hit to return and wealth. And the longer the process continues, the bigger the detraction from wealth.

## THE COST OF EXCITEMENT

This brings us to quality. In the investing world, high-quality companies are often dismissed as dull. They have stable earnings, conservative balance sheets, and rarely make headlines. But what they lack in drama, they tend to make up for in consistency.

By contrast, low-quality companies — often touted as "value stocks" with low multiples and high dividend yields — tend to be unstable. Their earnings fluctuate. Their debts are heavy. And their stocks can take you on a roller coaster ride. The fact of the matter is that cheap stocks tend to be cheap for a reason, and that reason often centers on quality or lack thereof. In Chart A on page 3, we clearly see that high grade, high quality companies tend to carry higher multiples and lower yield. This is consistent with bonds, too. High quality investment grade bonds almost always carry lower yields than high yield junk bonds. Bottom line — if the market is giving you a cheap, high-yielding stock it is more than likely the case that you are looking at a lower quality issue.

It is easy to be drawn to these companies because they appear cheap. But cheapness is not the same as value. What looks like a bargain is often a trap, and the volatility tax is part of the price you pay.

## THE EVIDENCE IS CLEAR

Over the last two decades, we've tracked the performance of stocks across different quality tiers—graded from "A" to "F." What we've found is this: "A" and "B" quality stocks outperformed "C", "D", and "F" when examining compounded returns over time. This is NOT to say that high quality won out every year. High quality did not win the past couple years, for example. But over a longer time, the advantage from consistency over excitement is plain to see.

Look at Chart B on page 4. Notice that as we go down the quality scale from "A" to "F", volatility increased. And with higher volatility the difference in returns between the average return and the compounded return is significant. This is the "volatility tax" in action. A 4.4% "tax" is levied against the high yield, high volatility "F" quality stocks and a much smaller 1.5% "tax" is levied against the lower yielding, lower volatility "A" quality stocks. This often overlooked mathematical artifact is almost always overlooked by investors, but it should not be. After all, this isn't just a theory. This math reveals how capital may compound — or fail to — over time.

## CHANGE AFOOT?

It's easy to chase the next big thing, jaw dropping growth, or big yields. In any given year, high or low quality can rule the roost. As we noted in a recent commentary, "Quality First — The Bedrock Principle," low-quality stocks dominated high-quality from early 2023 through early 2025. But this trend now appears to be reversing. Since February 18 of this year, as worries about tariffs began to take hold, high-quality stocks outperformed lower-quality stocks by a healthy margin (Chart C, page 4). Once again, when markets became unsettled, quality led the way.

There's a saying in football: Offense wins games, but defense wins championships.

Just like football, nothing is as exciting as a completed "Hail Mary" pass for the touchdown to win the game. These are the highlight reel moments that are the attention getters and put fans in the stadium. However, one only needs to look back at the most recent Super Bowl game to understand how impactful a strong defense is to overall team performance. The World Champion Philadelphia Eagles defense overwhelmed the Kansas City Chiefs, sacking KC quarterback Patrick Mahomes six times, forcing three turnovers, and holding the Chiefs offense nearly scoreless through three quarters of the game (all while blitzing 0%).

As you can see, excitement is usually the enemy if your goal is to build lasting wealth. Consistency tends to win out in the long run. And the path to consistency lies through quality.

In a world where volatility can exact a hefty hidden tax, quality really isn't all that dull after all.

**CHART A | WCA QUALITY GRADE** Source: WCA, Bloomberg

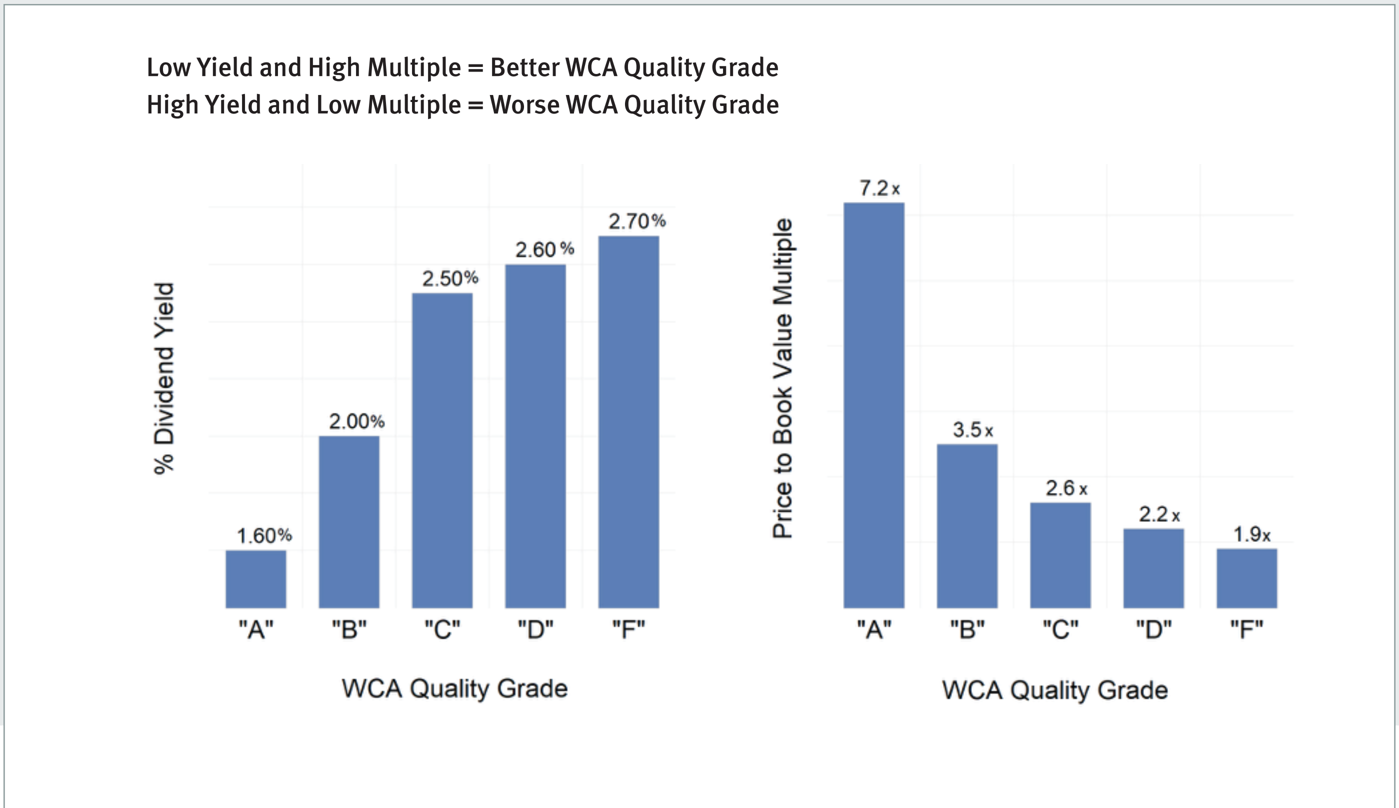
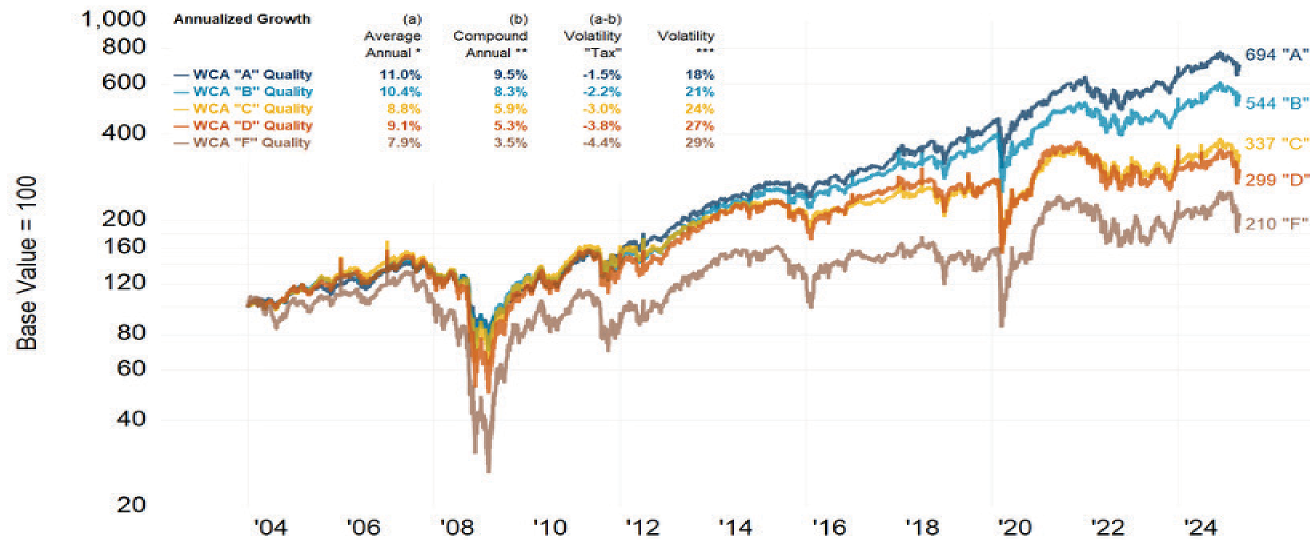
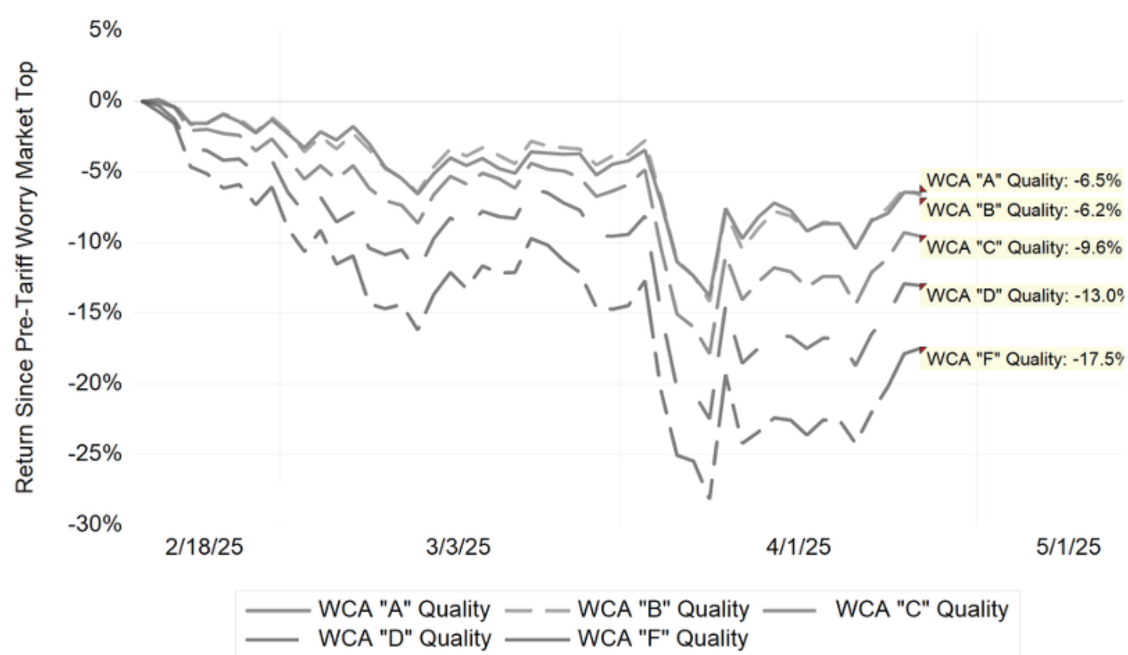


**CHART B | WCA QUALITY GRADE INDICES (12/31/2003 – 4/25/2025)** Source: WCA, Bloomberg




*Excludes impact of volatility on end value. **Includes impact of volatility on end value. ***Measured as annualized standard deviation.
The Washington Crossing Advisors' High Quality Index and Low Quality Index consist of the largest 1,000 U.S. stocks by market capitalization. After these stocks are determined, each one is assigned a letter grade (A, B, C, D, F) based on consistency (earnings and stock price volatility), leverage (debt/enterprise value), and profitability (return on assets). Companies that are assigned an A or B rating are considered higher quality, C is considered average quality, and companies with D or F ratings are viewed as lower quality. Past performance is no guarantee of future results.

**CHART C | QUALITY RETURNS UNDER TARIFF UNCERTAINTY** Source: WCA, Bloomberg



## IMPORTANT DISCLOSURES

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

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Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark.

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