Escaping the Scrum of Cable TV: Putting Volatility in Context

The market's ups and downs are not necessarily negatives for investors, if risk is properly understood and accounted for in financial plans

Volatility is a term which some advisors and most pundits unfairly use as a euphemism for losses — or as an imprecise substitute for risk. It is almost always viewed as a negative. At NAM, we define risk not necessarily as volatility, but as the potential for permanent loss of capital that would have a lasting impact on compounding wealth. In our view, volatility can present fresh opportunities to shift and rebalance portfolios or to introduce new investments, but these opportunities have to be evaluated carefully. In this *Market Perspectives* we contextualize recent volatility, offer our take on investor psychology and crowd behavior, and demonstrate why sound financial planning should include broadly defined risk metrics and a sensible risk-mitigation framework.

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We have all seen enough cable TV to know that our portfolio values tend to drop when the VIX Index, a measure of stock-market volatility, spikes.[1] Investors, especially long-only equity investors, would be right to conclude they are inherently short volatility, which essentially means they expect volatility to remain low most of the time. During periods when volatility increases, investors feel losses acutely, even if they are temporary. If they are compelled to sell and do not reinvest the proceeds, however, the losses are locked in and often painful. Careful readers of our market commentaries may recall events from a year ago, when an entire class of exchange-traded funds (ETFs) designed to benefit from continued low volatility collapsed in price. Their investors were, in hindsight, adding "fuel to the fire" and unfortunately suffered permanent losses.

When we strive to build durable, long-term portfolios, we often go the other direction and seek ways to "buy back" some of the volatility short position. We do this primarily by owning bonds, but also by diversifying some of the more volatile risk factors within equity portfolios, such as momentum, with securities that have indicated much lower levels of historical volatility. As with any hedge that could reduce risk, there is a cost: bond returns are generally lower over an economic cycle and lower-volatility equities tend to lag when markets rally.

From a planning perspective, we are using such offsets to reduce sequence risk — a powerful enemy of financial plans. Sequence risk (also called "sequence-of-returns" risk) can be particularly concerning to people who rely

[1] The CBOE Volatility Index, known by its ticker symbol VIX, is a popular measure of the stock market's expectation of volatility implied by S&P 500® index options.

on investment capital to fund their living expenses and healthcare needs. Selling out at or near the bottom of the market, or during an interim panic like we saw in the fourth quarter of 2018, can lead to dramatically different outcomes for such plans.

Understanding historical volatility

We are entering 2019 a full 10 years into a bull market for stocks and at least 30 years into a bull market for interest rates — a technology-driven deflationary boom! Does recent volatility in stocks and bonds signal an end to good times or is it fairly normal market behavior? While the S&P 500 finished 2018 in the red after a particularly difficult fourth quarter, it is not that unusual to experience sell-offs well in excess of the calendar year result (see Figure 1).

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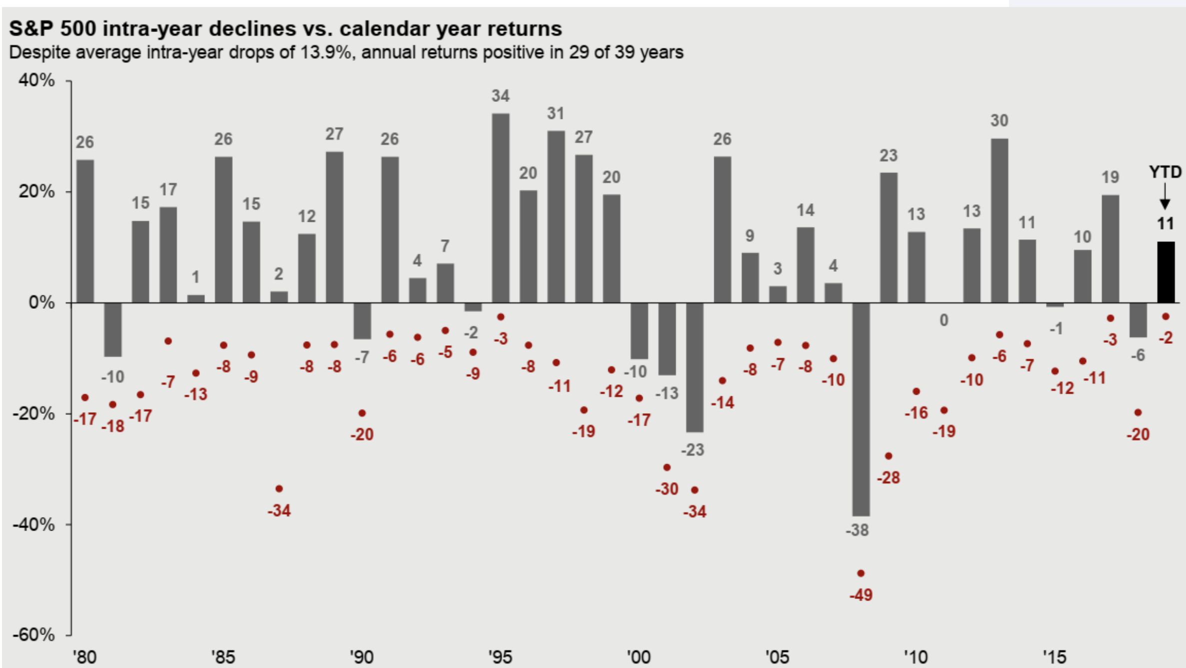
Figure 1:
S&P 500 Price Performance vs. Intra-Year Drawdowns Since 1980[2]



Source: J.P. Morgan Asset Management

Moreover, the market volatility we witnessed in 2018 was relatively mild and far less persistent compared to what occurred during the 2008-09 financial crisis. Then, in the worst U.S. economic disaster since the Great Depression, stocks as measured by the S&P 500 Index dropped 57%, peak to trough. The Index then recovered between March 2009 and January 2018, advancing 325%.[3]

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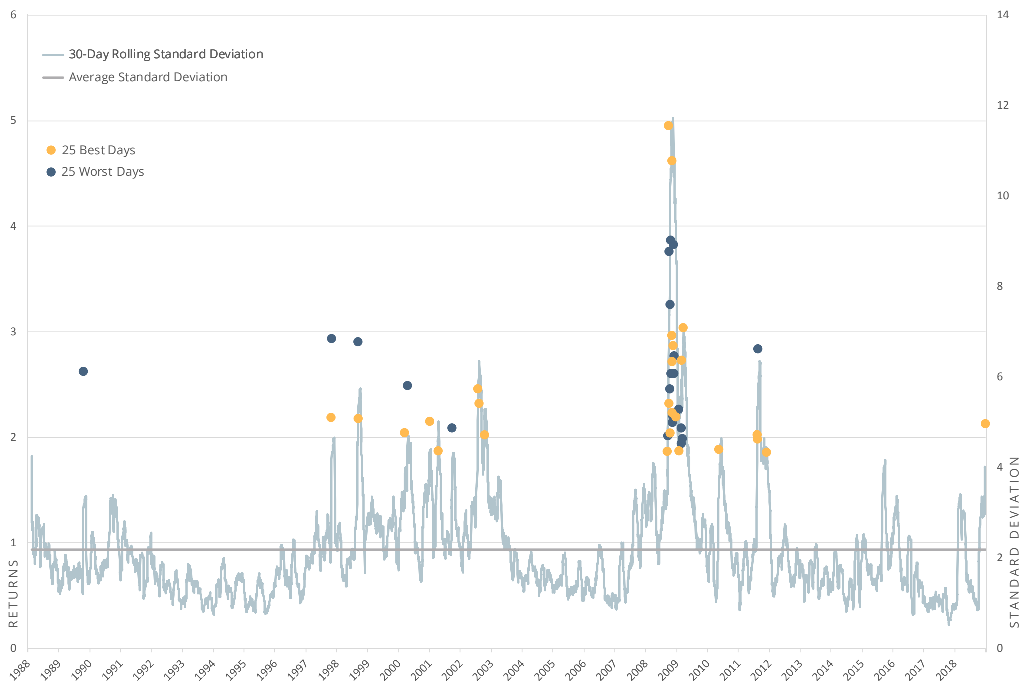
[2] Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refer to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2018, over which time period the average annual return was 8.4%.

[3] Stock Market Briefing: S&P 500 Bull & Bear Market Tables," Yardeni Research, Inc., Feb. 13, 2018. The market peak occurred on Oct. 9, 2007, and the trough on Mar. 9, 2009.

We can observe that volatility is back to normal levels, when compared to long-term trends. Since 1962, for example, there have been an average annual 169 intraday market swings of 1% in the S&P 500. In 2018 there were 110 intraday market swings of 1% or more in the S&P 500, compared with 10 in 2017.[4] As we have also observed in previous communications, 2017 set a record for the smallest number of [asset class declines since 1901](). To some degree, investors were spoiled in 2017 and lulled into complacency.

As the Fed attempts to move interest rates from abnormally low levels to something akin to historical averages, investors should expect volatility to remain elevated. This doesn't mean that long-term savers should abandon stocks. Research shows that the best and worst days to be in the market actually occur in similar environments — all when volatility is above average. It is difficult to avoid the worst days to be in the market. But by trying to miss the worst days, you will likely miss the best days, too. Figure 2 is a powerful illustration of the 25 best days (in green) and 25 worst days (in red) to have been in the market since 1988, as measured by the S&P 500 Total Return Index. Note how often these outlier extremes occur in clusters, when volatility spikes.

Figure 2: Volatility Clusters, 1988-2018



Outlier best and worst days to be in the market occur in clusters, when volatility spikes.

Source: FactSet, North American Management

If the recent bout of volatility in the markets is more of a return to normal, and the data show how costly it can be to liquidate under stress, how likely are market participants to act on emotion? We turn our attention to this phenomenon next and explore why it is so important to have a solid financial plan that is grounded on sensible risk metrics designed to minimize sequence risk.

[4] "Stocks end year with worst annual decline since 2008," *Boston Globe*, Jan. 1, 2019.

Psychology and market behavior

During volatile periods, when investors are more likely to see steeper declines, they experience what behaviorists call "myopic loss aversion." The more they look at their portfolios, the more pain they feel and the greater their tendency to react to recent losses — possibly at the expense of long-term benefits. In other words, they often sell low and buy high. Curiously, many investors tend to feel the happiest when they are at the highest market peril, and most despondent when the potential upside is greatest. For a nation of bargain-conscious consumers, this seems counterintuitive. The same people who bought a fire-sale refrigerator last fall from Sears might have been selling stocks when they were marked down 20%. All of these effects, when combined with emotion and overreaction, can serve to amplify and accelerate periods of rapid market gains and losses.

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Importance of sensible planning

We believe it is important that thoughtful planning techniques inform the asset allocation process. This process seeks to establish the right course for clients at the outset of our relationship, building a plan that matches asset allocation to client objectives, time horizon, and risk tolerance. Actively monitoring the plan to strike a balance between the portfolio's resilience to volatility, and the investor's ability and willingness to withstand market fluctuations, is particularly critical. An investor who anticipates needing liquidity within two to three years, for example, may not think it generally sensible to own a high percentage of stocks. Conversely, investors with a time horizon of two decades or more may be able to accept considerably more volatility.

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To that end, we generally want clients to own a balance of U.S. and non-U.S. stocks and bonds, in appropriate combinations that are designed to anticipate and respond to changes in market conditions and individual-security characteristics. In addition, we look to constantly reinvent and adapt our processes to protect client assets in down markets and allow them to participate in the upside when markets recover.

Whatever the situation, we advise clients not to get caught up in the 24/7 scrum of cable TV. For the most part, we attempt to minimize turnover to avoid getting whipsawed by volatility and stress the importance of looking forward when assessing opportunity.

Fortifying portfolios from excessive volatility

During episodes of market stress, correlations among historically uncorrelated asset classes sometimes begin to move in lockstep, as they did for much of 2018. During extreme conditions last December, however, the benefits of diversification re-emerged as volatility spiked. Figure 3 lists in descending order of contribution the counterweight strategies that benefited investors amid the panic selling in December, along with the associated "cost" of each noted in parentheses:

Figure 3: Counterweight Strategies to Market Volatility

1. Own investment grade corporate bonds, treasuries, or cash (lower long-term returns)
2. Own less volatile, higher quality stocks (probable lag during broad market rallies)
3. Diversify by geography and market capitalization (cost has been high since 2011)
4. Invest in hedge funds or other alternatives (relatively high fees, higher selection risk)

Conclusion

The keys to dealing and living with volatility cannot be simply reduced to managing emotions and deftly navigating the markets. Most investors recognize that they will need to own stocks in order to reach their goals. Still, that does not negate the gut-wrenching feeling that many experienced in late 2018 from volatility in the stock market — even if the order of magnitude of "heartburn" compared to 2008-09 was far lower.

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We remind our clients and readers that risk is best defined as a permanent loss of capital, not volatility itself, and for most long-term portfolios the predominant driver of risk comes from stocks. Above all, we believe it is critical for our relationship managers and investment professionals to spend time with our clients, in different market environments, so that we really know and deliver what they expect from us, wherever the markets may be heading.