

OUTSIDE THE FLAGS

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Living with Volatility, Again

Volatility is back. Just as many people were starting to think markets only ever move in one direction, the pendulum has swung the other way. Anxiety is a completely natural response to these events. Acting on those emotions, though, can end up doing us more harm than good.

There are a number of tidy-sounding theories about why markets have become more volatile. Among the issues frequently splashed across newspaper front pages: global growth fears, policy uncertainty, geopolitical risk, and even the Ebola virus.

In many cases, these issues are not new. The US Federal Reserve gave notice last year it was contemplating its exit from quantitative easing (an unconventional monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective). Much of Europe has been struggling with sluggish growth or recession for years, and there are always geopolitical tensions somewhere.

In some ways, the increase in volatility in recent weeks could be just as much a reflection of the fact that volatility has been very low for some time. Investors in aggregate were satisfied earlier this year with a low price on risk, but now they are applying a higher discount rate to risky assets.

So the increase in market volatility is an expression of uncertainty. Markets do not move in one direction. If they did, there would be no return from investing in stocks and bonds. And if volatility remained low forever, there would probably be more reason to worry.

As to what happens next, no one knows for sure. That is the nature of risk. In the meantime, investors can help manage their risk by diversifying broadly across and within asset classes. We have seen the benefit of that in recent weeks as bonds have rallied strongly.

For those still anxious, here are seven simple truths to help you live with volatility:

1. Don't make presumptions.

Remember that markets are unpredictable and do not always react the way the experts predict they will. When central banks relaxed monetary policy during the crisis of 2008-09, many analysts warned of an inflation breakout.

If anything, the reverse has been the case with central banks fretting about deflation.

2. Someone is buying.

Quitting the equity market when prices are falling is like running away from a sale. While prices have been discounted to reflect higher risk, that's another way of saying expected returns are higher. And while the media headlines proclaim that "investors are dumping stocks," remember someone is buying them. Those people are often the long-term investors.

3. Market timing is hard.

Recoveries can come just as quickly and just as violently as the prior correction. For instance, in March 2009—when market sentiment was at its worst—the S&P 500 turned and put in seven consecutive months of gains totalling almost 80%. This is not to predict that a similarly vertically shaped recovery is in the cards, but it is a reminder of the dangers for long-term investors of turning paper losses into real ones and paying for the risk without waiting around for the recovery.

4. Never forget the power of diversification.

While equity markets have turned rocky again, highly rated government bonds have flourished. This helps limit the damage to balanced fund investors. So diversification spreads risk and can lessen the bumps in the road.

5. Markets and economies are different things.

The world economy is forever changing, and new forces are replacing old ones. This applies both between and within economies. For instance, falling oil prices can be bad for the energy sector but good for consumers. New economic forces are emerging as global measures of poverty, education, and health improve. A recent OECD study shows how far the world has come in the past 200 years.¹

6. Nothing lasts forever.

Just as smart investors temper their enthusiasm in booms, they keep a reserve of optimism during busts. And just as loading up on risk when prices are high can leave you exposed to a correction, dumping risk altogether when prices are low means you can miss the turn when it comes. As always in life, moderation is a good policy.

7. Discipline is rewarded.

The market volatility is worrisome, no doubt. The feelings being generated are completely understandable and familiar to those who have seen this before. But through discipline, diversification, and understanding how markets work, the ride can be made bearable. At some point, value re-emerges, risk appetites reawaken, and for those who acknowledged their emotions without acting on them, relief replaces anxiety.

1. "How Was Life? Global Well-Being since 1820," OECD, October 2, 2014. http://www.oecd-ilibrary.org/economics/how-was-life_9789264214262-en.



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