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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

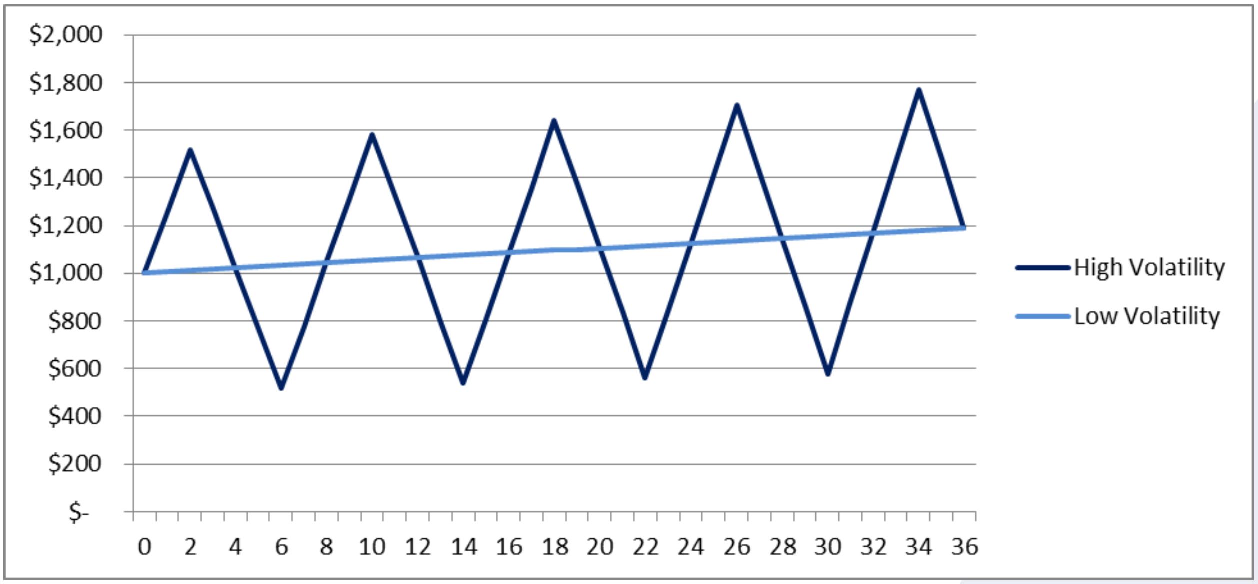
Don't Mistake Low Volatility for Low Risk

One of our Cadence advisors can recall a time he was speaking with someone who confessed she was a conservative investor because she only invested in blue chip stocks. When you factor in this person was well into her retirement, you have enough information to know that she was exposing herself to considerably more investment risk than she realized. What would lead someone to believe that putting 100% of his or her money in stocks qualified as conservative?

We can be lulled into a false sense of security when increasing asset values go an extended period of time without experiencing much volatility. We have statistical ways of measuring volatility, but for the average investor volatility is something seen in statements and on television. When your returns seem to be bouncing around month to month and people on TV seem to be animated describing what just happened and what might happen next, that's an indication volatility may be occurring.

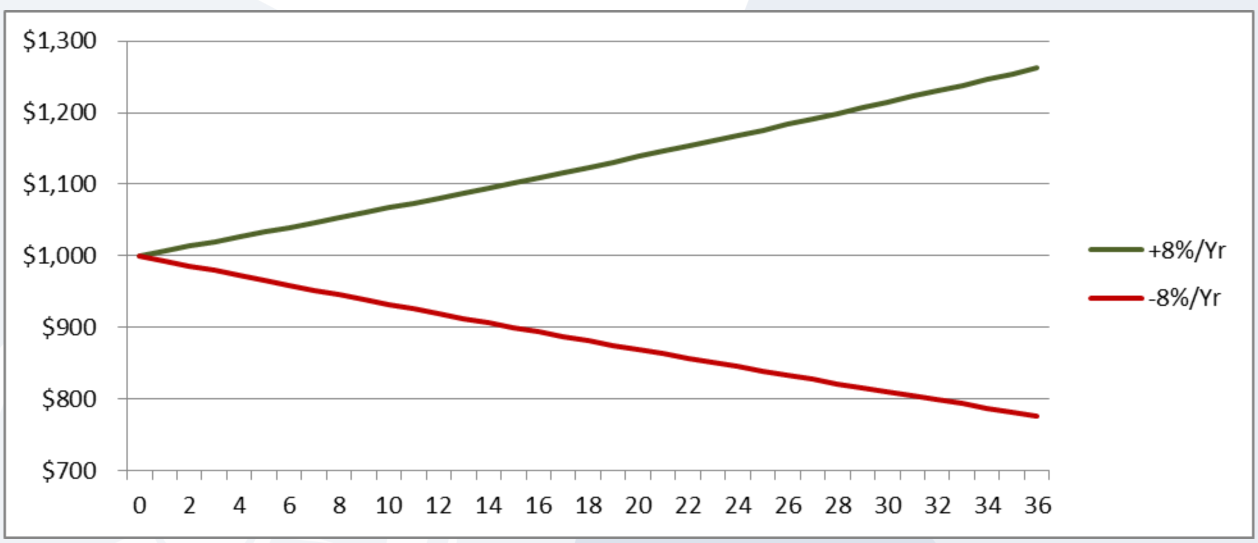
But the flip side of that coin is very hard to detect, and that is when volatility is unusually low. Frequently there's little evidence to see when this happens. People on television aren't going too crazy, investment statements seem to be increasing steadily, and when they do decrease it's never for more than for a month or two, and it's never by much. This is when people's perspective on risk can become distorted. The longer an investment or a portfolio chugs along making steady gains and the smaller and shorter any negative spells are, the easier it is to think there's less risk out there than there is. Some investments are designed to provide low volatility on a routine basis, although they are certainly not immune to their own volatile moments.

Low volatility can frequently be masked by moments when the market has lost an uncomfortable amount of value, or has risen to dizzying heights. Anecdotally it can be difficult to measure, but volatility in our office is defined by how much an investment's periodic return fluctuates around its average return, and it can be measured. Think of it as how much the values of your investments seem to jump up and down over time. Consider two investments' performances over a three year span:

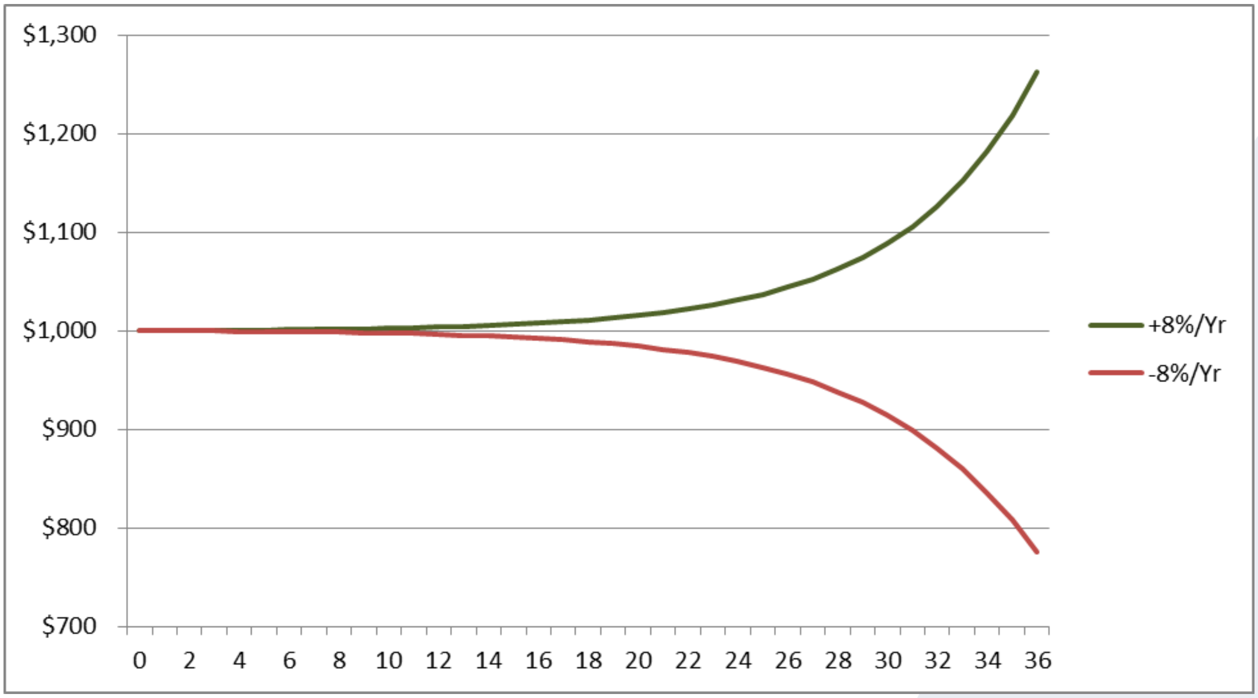


Both investments return an average of 6% per year over the time period, but one is significantly more volatile than the other. In fact, one returns less than 6% nearly half the time, while the other always earns 6%. In this example it's easy to see that if your goal is a 6% return, one way seems to be much safer than the other.

Steady movements both up and down can have low volatility. Consider these two investments. Although one returns +8% annually and the other loses -8% annually, they have identical low levels of volatility:



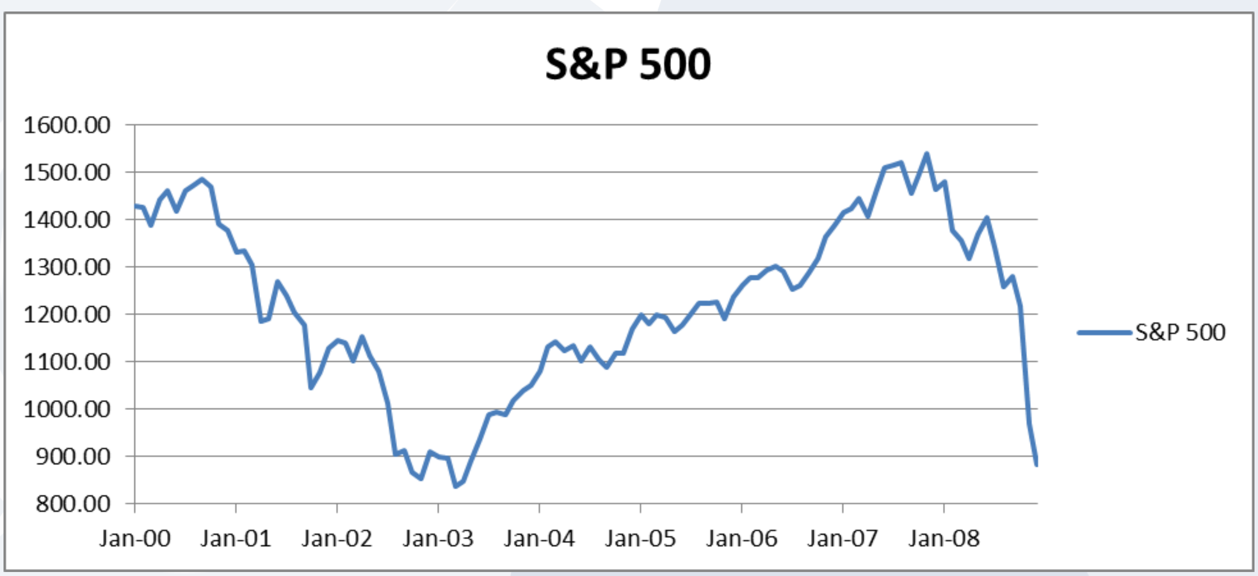
To take this idea one level deeper, consider two more investments that also gain and lose 8% per year as above, yet whose returns are becoming increasingly volatile:



So even though these two investments gain and lose the same amount as the two before them, they are much more volatile. Not initially, but as time goes on and as the gains and losses accelerate.

These examples are simplified to prove a couple points: volatility can be low or high for the same rate of return, and it can be low or high whether an investment is increasing or decreasing in value.

What we have noticed is that low volatility can be happening while people are becoming complacent with their positive returns, like we found with our blue chip investor, or are becoming resigned to their negative returns. In both situations, investors have a false sense that what has been happening is just going to keep happening. In July's issue we identified this as the recency bias. This is why people get comfortable loading up on risky assets in good times, and pull their money from the markets entirely at bad times. Consider S&P values from January of 2000 when the tech crash was beginning through December of 2008 when the financial crisis was a few months from bottoming out:



As the market peaked in 2000, as it bottomed out in 2003, and as it peaked again in 2007, volatility as measured by the standard deviation of annual returns was hitting equally low levels. In fact between January of 2000 and October of 2007, the only time that volatility measure hit those low levels was as the S&P was either peaking or bottoming out.

Since 1950, the standard deviation of annual returns has hit extremely low levels roughly 20% of the time, which was 18 periods of differing time frames over those 64+ years. Of those 18 periods, five of them were while the market was bottoming out, six of them were while the market was roughly half way through an upswing, and seven of them were within months of the market losing at least 20%. So unfortunately what low volatility does not guarantee is what the market is going to do next. However, what it does seem to indicate is that when the market loses at least 20%, it is likely that volatility was unusually low shortly before that tumble started.

Which brings us to why we are cautious about the value of the stock market today. It appears to us that one situation that has historically shown to be worth paying attention to is when the market has steadily run up over a period of time, usually to new highs, and when volatility is extremely low. Those two conditions exist today. A correlation between stock market losses of 20% or more after market run-ups and during periods of low volatility does seem to exist. In the 9 stock market crashes of 20% or more since 1950, 7 of them corresponded to periods of very low volatility.

When volatility's much lower than normal, it can be easy to view an investment as being safer than it actually is. Whether it's stocks, bonds, or something else, every asset class experiences periods of relative complacency and calm. Just because big price swings in both directions haven't occurred, it doesn't mean they won't - risks still exist. Discounting these risks, especially after prices have risen significantly, could prove costly. Just ask the investor who thought they were conservative with a 100% blue chip stock portfolio after the financial crisis of 2008.

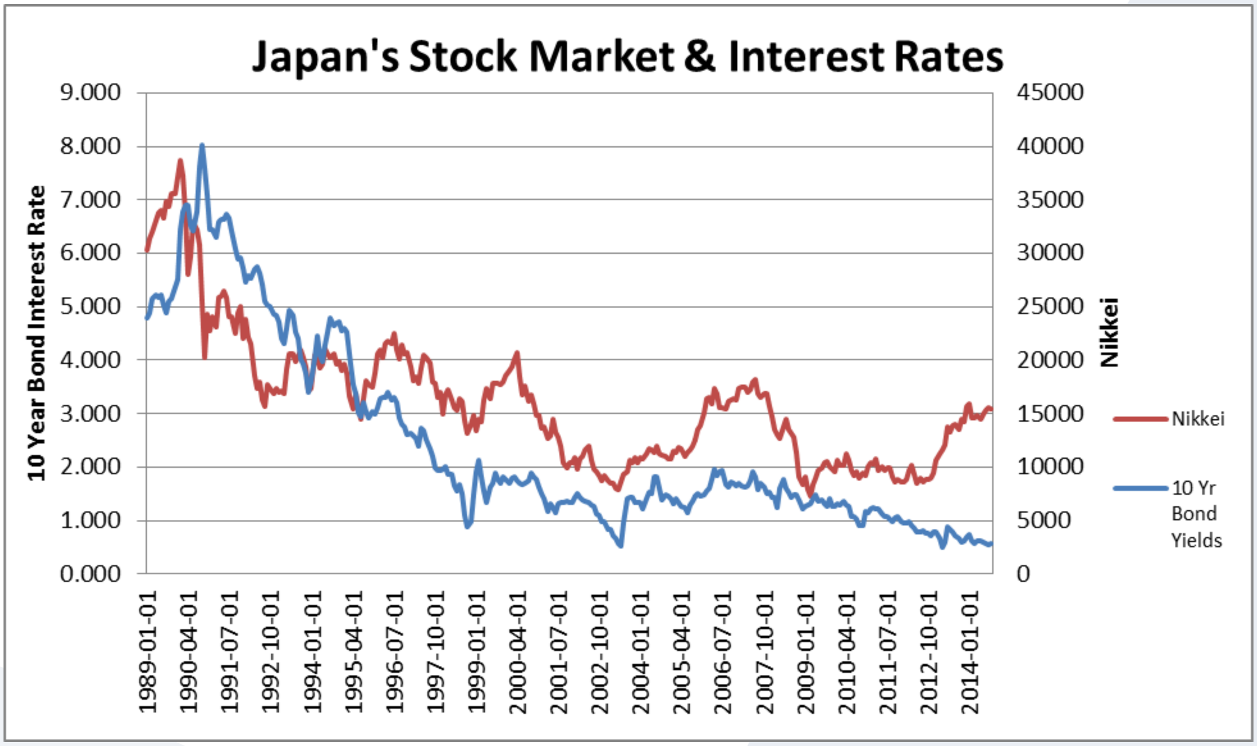
Stock Markets and Interest Rates

There's an argument that's been making its way around Wall Street and the financial media for so long now that it runs the risk of being taken as true. The argument goes that as long as interest rates stay low, then the market should continue to run up. On its face, the logic makes sense. With cash and bonds paying such low rates, investors will opt for stocks instead. And with borrowing costs so low, companies will continue to take on new debt and invest for growth, driving their earnings higher.

The first problem with this logic is that it lacks a time frame. At some point, even with rates on traditionally safer stuff annoyingly low, stock markets would reach a level where even the most reckless investors would have pause. In addition, corporations borrowing at these low rates would run out of productive investments that boost their bottom line. As we've seen in the past, this reach to find things to buy with cheap money can lead to questionable investment decisions and dangerous amounts of leverage that can get unwound in a hurry if winds happen to change directions even in the slightest.

The second problem with the low rates equals higher markets argument is that it doesn't always consider the reason rates are low in the first place. If rates are low solely because central banks decided they should be, then stock markets would most likely benefit. This is what we've experienced over the last few years since the 2009 market low. Corporations have borrowed and boosted profits, and investors have been enticed into stocks due to lack of any better options. To this extent, low rates have worked and the sequence of events has supported the argument. But what if rates were low due to underlying economic weakness? If our economy, without central bank support, wasn't growing that quickly, and inflation was low as a result, couldn't rates be lower? And wouldn't this environment be a tough one for stocks as well? We believe so.

Let's look at Japan for perspective. Rates on the 10 year Japanese Government Bond dropped below 3% in the mid 1990's and haven't been higher since. It's worth noting that before their stock and real estate market bubbles burst in 1990, the 10 year interest rate was around 5% - very similar to what we were accustomed to in the U.S. before 2008. So with these lower than average rates below 3%, the economy and markets should have gotten a lift. Investors should have invested in stocks and corporations should have borrowed and driven profit growth, but neither of those things happened. The Japanese stock market is still about 24% lower than it was when rates first fell below 3% almost 20 years ago.



After decades of economic growth, most of which in the latter years were fueled by credit expansion and tremendous leverage, the painful process of unwinding all the excess set in. Rates were low because debts were being paid down rather than new loans taken out, demand for goods and services was lower, inflation was non-existent (in fact prices were actually going down in most cases) and investors were happy to earn low rates of interest as long as they weren't losing money. In fact with consumer prices dropping, low interest rates were still allowing the average citizen to grow their purchasing power every year. If you earn 2% on your bond while prices drop 3%, then you've effectively gained 5%. As long as the Japanese economy was still ridding itself of the excess from the previous debt-fueled binge and was mired in deflation as a result, rates stayed low all while the stock market continued to deflate.

Are we bound to follow in Japan's footsteps? That's a question with too complex an answer to tackle here. What we can say, however, is that it may be detrimental to assume that markets will continue to rise simply because interest rates are low.