PORTFOLIO PERSPECTIVES

Volatility Is Back and So Is The Noise!

By Sheldon McFarland
VP, Portfolio Strategy & Research
Loring Ward

It was an illusion that caused the dog to lose his morsel of meat in Aesop's fable. According to the ancient Greek storyteller, a dog stole a scrap of meat from the butcher's shop and ran away until he came to a river. While crossing the river the dog looked down and saw what appeared to be another dog carrying a more desirable piece of meat. The tantalizing morsel turned out to be his reflection and the dog dropped his scrap while lunging at the illusion. Chasing after the illusion cost the dog his prize.

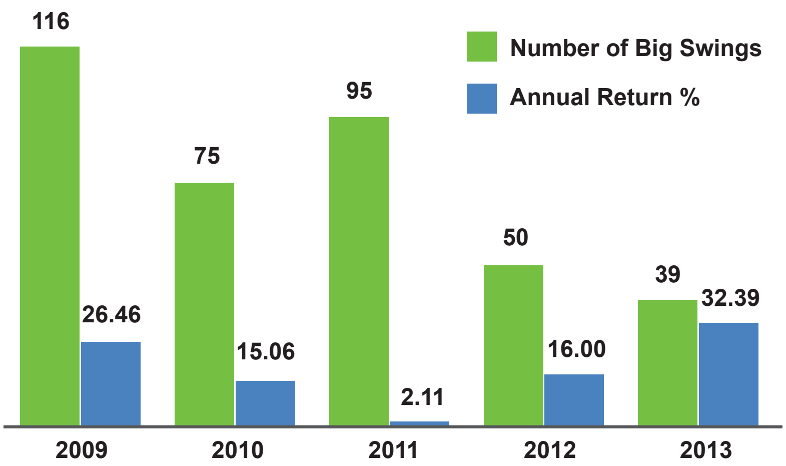
The world is full of illusions. These illusions — often called noise — are distractions from the truth. Noise causes us to lose sight of what is real. The noise — the dog's reflection — caused the dog to lose sight of reality — the morsel in his mouth.

The constant flow of news and information makes it incredibly difficult to see reality through what is really just noise. Traders don't file explanations with their buy or sell orders so media stories and pundit statements are usually little more than educated guesses — and sometimes not even that educated.

Volatility came back in October and with it came the noise. We saw markets decline significantly for the first time in years. There are a number of neat-sounding theories as to why — economic weakness and the Ebola crisis are surely factors — but nobody is entirely sure why. From time to time, there's a clear event that causes the market to move (a Fed decision, a jobs report, etc.), but most of the time the relationship between news and market movement is more subtle and unclear than people believe.

In some ways, the increase in volatility last October may just be a reflection of the fact that volatility has been low for a while. October saw the U.S. stock market rise or fall by at least 1 percent 12 times, the most 1 percent swings since November 2011. What investors forgot is that these swings happen all the time. It happened 39 times in 2013, 50 times in 2012, 95 times in 2011, 75 times in 2010, and 116 times in 2009. In other words, big swings in the market happen dozens of times a year — and usually mean absolutely nothing!

Big U.S. Stock Market and Annual Returns



Source: Morningstar 2014. U.S. Stock Market represented by the S&P 500 Price Index. Big swings defined as daily price movements greater than 1% absolute value.

Economist Eugene Fama won a Nobel Prize for demonstrating that the stock market is a "random walk" — its short-term moves don't reveal anything about the long-term trend. This fact is seen in this chart, which shows the annual return and number of big swings in the U.S. stock market each year since 2009. The best return over the last five years came in 2013, the year with the least big swings. The second best return was 2009, the year with the most big swings. The number of big swings had no bearing on the market's return for the year.

Maybe the most deceptive investment illusion of all is the fact that pundits make it sound so easy to time these market gyrations. Market timing is difficult. Recoveries can come quickly. 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 totaling over 50%. Markets are unpredictable and don't always react the way experts predict.

There is a lesson for investors in Aesop's fable. The next time the stock market ride gets a little bumpy and the pundits start giving their tidy explanations of what is happening and where the market is going, remember what happened to the dog when he reacted to the noise of his reflection in the river. The world is full of information but most is just noise that we consume without much regard for the distortions that it causes. If we lose sight of where we are going and react to that noise we might just end up like the dog that lost his morsel.