Volatility Is The Price Of Admission To Financial Markets

If it feels to you as if volatility has returned to the stock market, you?re right. But, although we?ve had a bad month in October so far with a nearly 10% loss in U.S. stocks, the calm we?ve had over the past few years is more unusual. And that makes this volatility feel worse than it should.

Garden Variety Correction

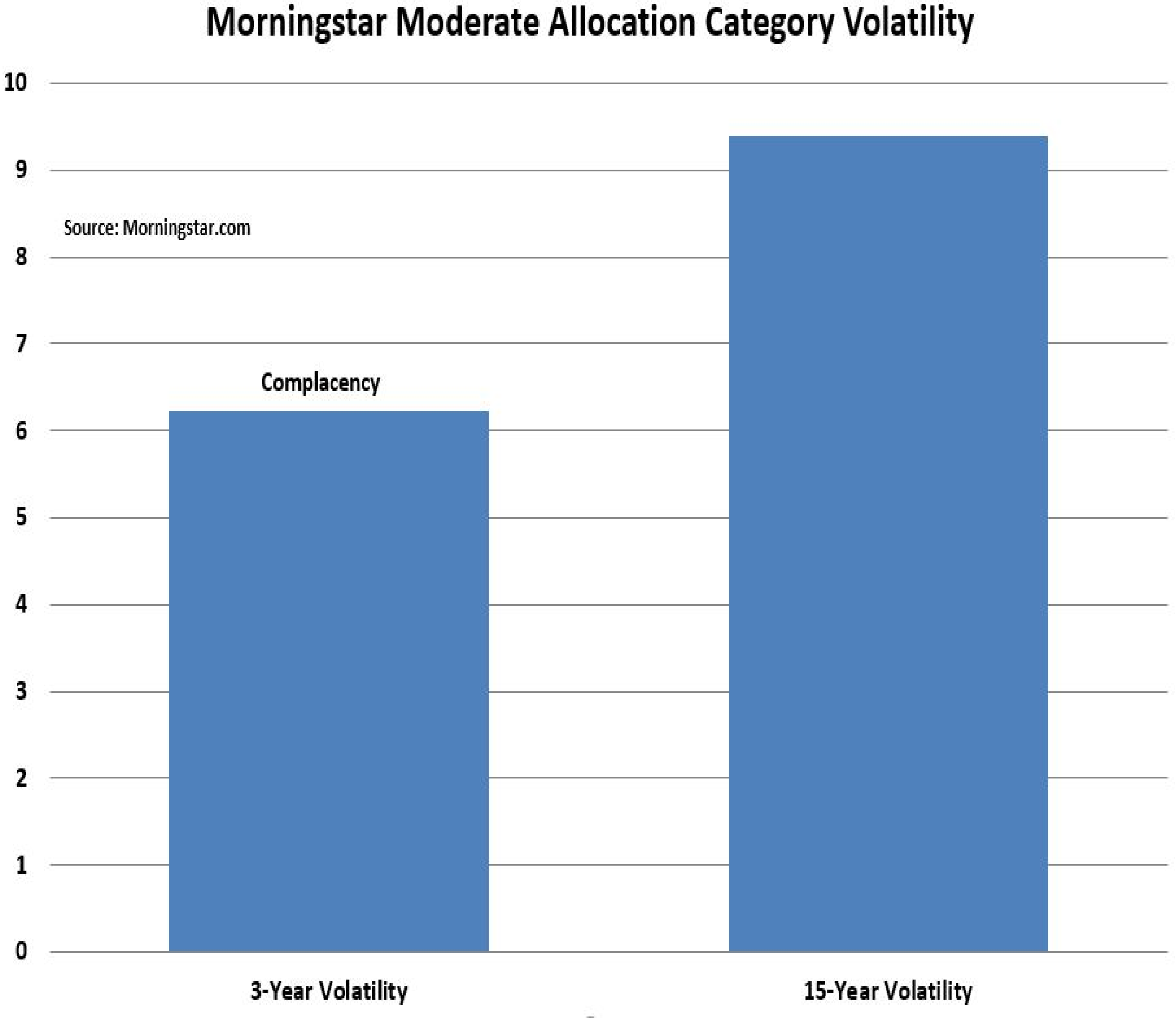
Here are a few statistical facts that should put the recent volatility into perspective. First, the S&P 500 Index was up around 11% for the year at its recent peak, including dividends. Now, through Wednesday, October 24th, it?s up 0.88% for the year. That means we?ve had a garden variety correction of around 10% so far. A bear market would be a decline of 20% from the market peak, and that would mean stocks would have to drop around another 10% from here to achieve that. It?s possible that will happen, but, even if it does, we?re only halfway there at this point. And if we do enter a bear market, that won?t be so unusual either. We haven?t had one since the financial crisis and recession of 2008, after all, and this is now the longest running bull market in history. In fact, the length of the bull market, which started in March of 2009, is what makes any volatility feel unusual ? even an ordinary 10% correction.

Calm Creates Complacency

Another important statistic that makes this correction feel unusual is that the S&P 500 Index didn?t drop in a single month in 2017 as it posted a nearly 22% return for the year. That was the first time in history the index didn?t record a negative month in a calendar year, and periods marked by such calm, especially if they come during &#2013266080;the longest bull market in history, make investors complacent. There is a tendency for investors to feel invulnerable after such periods, even though that kind of calm should make investors nervous about when the next bout of volatility will arrive. The human mind doesn?t work that way though. Behavioral economics has shown that we have a strong tendency toward ?recency bias,? meaning we extrapolate whatever hash happened in the recent past onto the future. That often makes us nervous when we should be calm and a little too calm when we should be a little nervous. It?s true that at the beginning of this year volatility arrived again in February and March when the stock market gave up the roughly 10% gain it achieved during the first few weeks of January. But then calm ensued, and the market marched up nearly uninterrupted to match its earlier gain from January. By the beginning of October, complacency and recency bias had set in again.

Bonds Bring Ballast

Consider also that bonds have done their job by holding steady and bringing ballast to portfolios while stocks have dropped. The Bloomberg Barclay?s U.S. Aggregate Index is down 0.55% for the month of October. It?s true that you might expect bonds to be up a little for the month. It often happens that stock market declines cause a rally in investment grade corporate and especially government bonds, so a slight decline in the main bond index is a little unusual. But it?s nothing extreme, and having a part of your portfolio so stable when the stock market is declining can be a blessing. This leads us to consider a balanced portfolio, which usually consists of 60% stocks and 40% bonds. This classic allocation has served generations of investors well with its moderate risk/reward profile, and it happens that a domestic index balanced portfolio is down a little less than 1% for the year through October 24th. A global balanced portfolio is down more ? around 4%. But that?s not catastrophic either. Also, the historical ?standard deviation? or volatility of a moderate or balanced allocation has been around 10%. That means investors can expect a range of returns within 10 percentage points in either direction around such a portfolio?s average return of 7% per year. So far, we are within that tolerance. And standard deviation isn?t perfect; it only captures most of the deviations around the average return, not all of them. There are times when balanced portfolios will have a wider range of return including losses than a 10 percentage point deviation around the average return. But we are nowhere near these larger losses yet. Here, again, investors may be fooled by recency bias. Morningstar?s moderate allocation category has delivered a standard deviation of over 9% for 15 years, but only around 6% or one-third less for 3 years.



Overall, investors should remember that although October has been a bad month, the volatility we?ve experienced over the past few years is well below average. October has been a reminder that volatility is part of the *?price of admission?* to the financial markets.