Infomail

August 31, 2015

Volatility on Steroids

"Traders can cause short-term volatility. In the long run, the market must revert to a sensible price/earnings multiple"

Ben Stein

The past week's market action reminded investors that market advances typically take the stairs up, while market declines typically take the elevator down. Giant market declines like the one we witnessed last Monday where the Dow Jones dropped over 1000 points in the first ten minutes of trading have simply become a fact of market life.

Monday's big downward open was rumoured to be attributed to a large hedge fund unwinding a losing currency trade and selling S&P 500 futures to hedge the risk. It has zero to do with the US economy or earnings, yet investors followed suit and jumped on the wagon and hit the sell button. Those who did probably regretted it within 48 hours.

It seems market performance is now driven by such things as weather, terrorism, geopolitics, fanatics and short term investor behavior. With 84% of all trading now being done by high frequency computers, and only 16% done by human traders, sentiment has become a more important market mover than the facts it seems.

It seems investors are constantly obsessed with the unknown, the "Black Swan" event that will have a market impact, rather than the threat of the Federal Reserve's actions, US debt, the impact of earnings, etc…

There are certainly market impacting events occurring. China's currency devaluation was a final capitulation by Chinese officials that their situation seems dire. The strong US dollar has been a major headwind for emerging economies, and their equity markets have been hurt the most.

Monday’s opening plunge was bad enough, but it was the extreme swings of the day and those that followed that seemed to scare investors more so. Over five days, the Dow Jones swung, on an aggregate basis, over 10,000 points when all added up. This is volatility I’ve rarely seen over my 30+ years, and it is not fun for investors or “traders.” It’s volatility on steroids.

But what happens is these downdrafts bring out the naysayers to rouse up more fear among investors. You saw the “talking head pundits” on various forms of media, calling for a 20% or 30% decline or even a crash. Many I saw said there was “no reason to buy.” Really? Over 14 billion shares traded on Monday, so somebody was buying on the other side of those sells.

What was interesting watching the action on Monday, was watching what got hit the hardest: Exchange Traded Funds (ETF’s). ETF’s have become the tool for inexperienced investors who lack the access or credentials to play the markets, and to reduce costs. The ETF sector has gained traction in recent years, now over $2 trillion is held in them in the USA. They are marketed as low fee alternatives to mutual funds, ETF’s simply track a selected block of stocks, and can be bought in almost any category. Most ETF’s are mundane, un-exotic tools, but it is interesting how some reacted in Monday’s mayhem.

The Vanguard Consumer Staples Fund was down 32% at one point, while the underlying basket was down only 9%. The I-Shares Select Dividend was down over 30% as well. In 15 minutes, the SPDR S&P Dividend ETF – one heavily sold in TV ads – dropped 33%. The only explanation for those being down 3-4X what the market was would be that “stop loss” orders entered by naïve investors were triggered by the quick fall, and those investors would have locked-in heavy losses.

One of the largest traded ETF’s, the Powershares QQQ (Nasdaq 100) was down 17%. The shares that make up that basket did not drop anywhere near 17%.

Hundreds of ETF’s simply disintegrated, and that’s why we prefer for the most part to use active managers, most of which used the panic to buy.

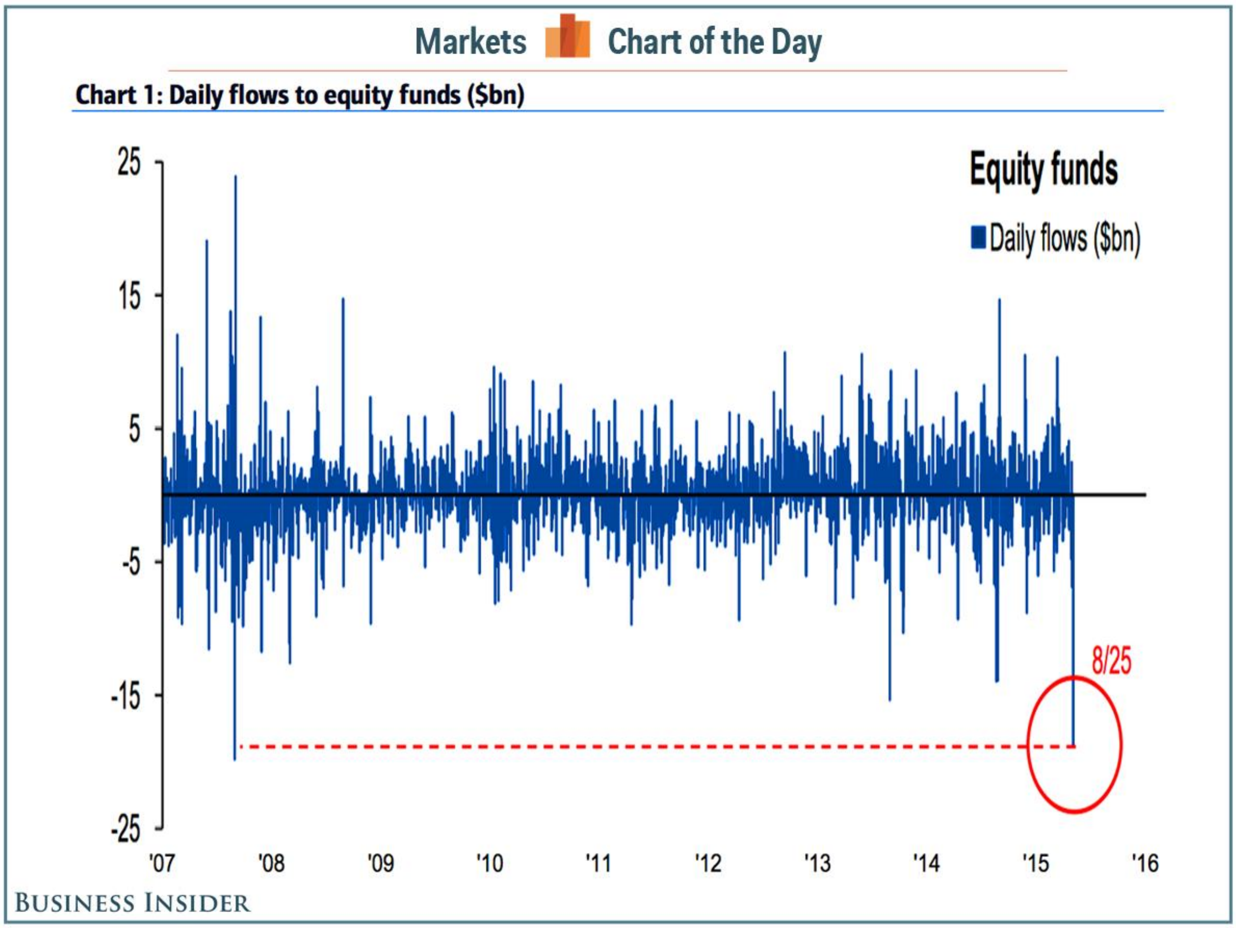
It will take regulators months to sort out the causes behind Monday’s rapid meltdown. Our advice has been the same: don’t panic. Sure, some corrections turn into bona fide bear markets, but in this case I believe it is a correction in an ongoing secular bull market.

Over the last 20 years we've seen some wicked corrections:

- ✓ 1997 Asian Financial Crisis
- ✓ 1998 Russia/Long Term Capital Management (LTCM)
- ✓ 2001 9/11
- ✓ 2011 Greece

All these events raised volatility, caused some short term "agita," and in retrospect were all "silly" reasons to sell, and great buying opportunities.

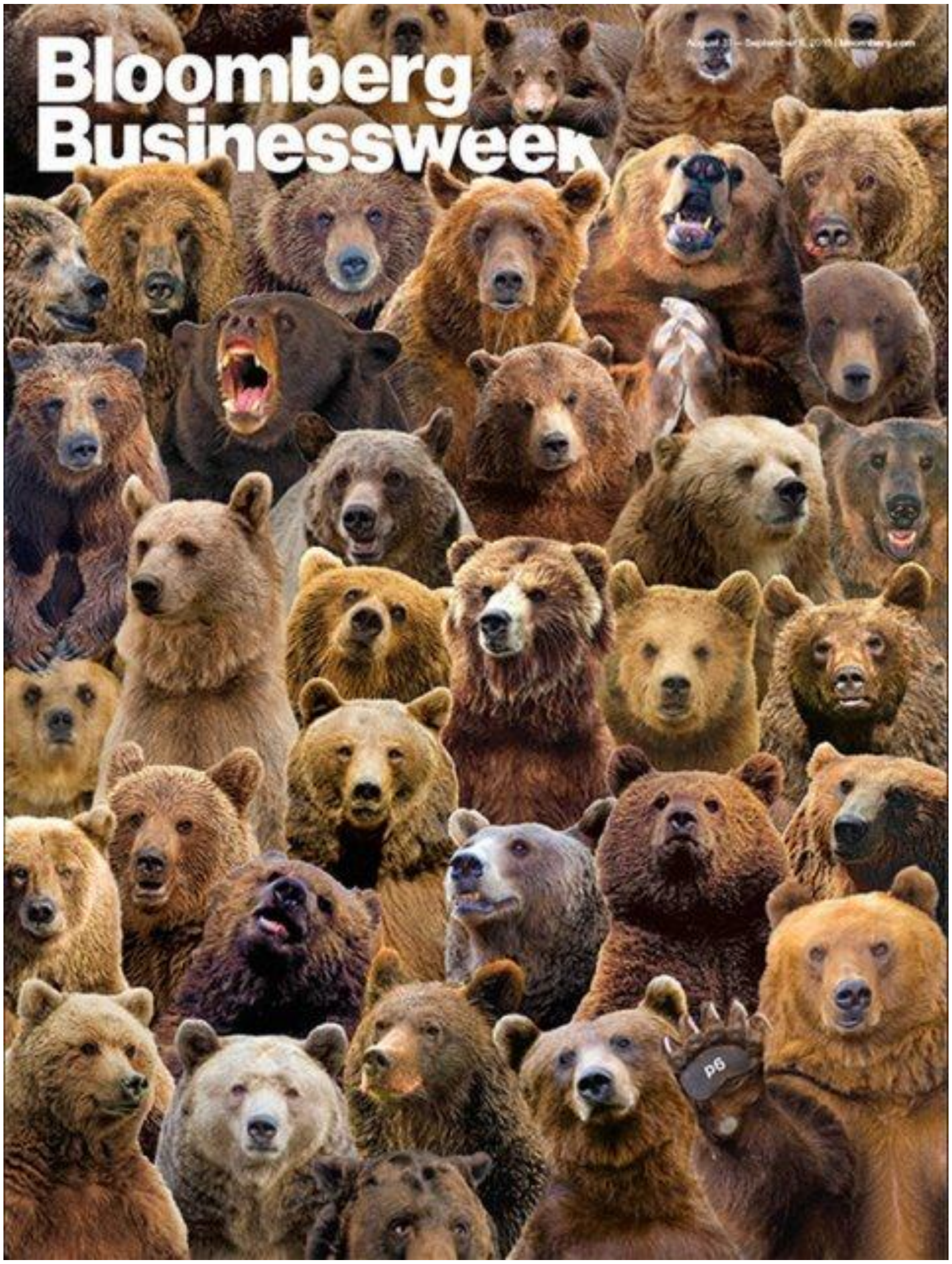
Last week saw the greatest exit from equity funds since 2008, as outlined by the chart below.



Ignore the doomsayers, maintain a diversified portfolio, and don't react to what's already happened. There will be more big swings in the future. Think about it, if there weren't any big down days/weeks, there would never be a premium on equity investing, and stocks would not provide superior long term returns.

Volatility is the price of admission for higher long term returns.

Finally, I leave you with the cover of this week's Bloomberg Business Week Magazine. If this isn't contrarian……



Stay tuned,

Vito Finucci

Vice President and Director
Investment Advisor