Market Volatility Returns: A Rude Awakening

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Market volatility has returned and if it seems like a jarring wake up; blame it perhaps on a market that lulled investors into a deep sleep.

By nearly any measure, stocks enjoyed one of their most tranquil periods in history between 2013 and 2017. A byproduct of the lullaby market is that many investors came out of it groggy and have been slow to react to the more normalized volatility regime that emerged last year. The good news: there's still time to respond.

KEY TAKEAWAYS

- Stocks have enjoyed several years of tranquility causing investors to be slow to react to a more normalized market volatility regime.
- A byproduct of the market's calm period is that investors may be more complacent and less prepared for the return of volatility.
- Advisors will need to help clients prepare for normal volatility and the eventual bear market.

For more perspective on recent market volatility and whether clients are prepared, it first helps to have context on the market environment that preceded it.

Markets and Deep Sleep

Scientists classify sleep into distinct stages: light stages of non-REM sleep, a deep non-REM stage and finally, the REM stage in which we experience dreams. As the name suggests, it's hardest to wake up in the deep sleep stage. At this point, the brain produces delta waves, muscle activity ceases and we become virtually unresponsive to outside stimuli.

Given the recent market environment, it would have been easy for investors to fall into deep sleep mode. With accommodative monetary policy acting like melatonin, investors shrugged off slow global economic growth and geopolitical instability, and until 2018, stocks marched upward.

It's been an impressive climb, not just for the level of appreciation, but the steadiness of the trajectory. A few statistics highlight how relatively calm markets were leading up to 2018:

- In 2017, the most standard measure of market volatility, the VIX Index, hit its lowest level since at least 1993. From 2013 through 2017, the VIX averaged 14.40, well below its long-term average of 19.37.*
- In 2017, the S&P 500 Index notched gains in each calendar month, a feat not achieved since 1950. Meanwhile, the index never registered a 2% down day. Normally stocks experience seven or eight per year.**

Novice investors will need help preparing for normal volatility and the eventual bear market.

- Another way to gauge market volatility, or a lack of it, is in the days in which markets moved by 1% or more. Over the last 20 years, three of the four calendar years with the least days of 1% movers were 2017, 2013, and 2014. Those three years experienced 34, 70 and 71 days in which the index moved 1%. For perspective, the annual average over that period was 112.
- By February 2018, markets had gone 80 weeks without a 5% correction. Normally, that occurs every 10 weeks.[†]

Waking to Normalcy

A byproduct of the market's calm period is that investors may be more complacent and less prepared for more normal volatility levels. Asset flows indicate this could be the case. In 2017 and 2018, investors piled an additional $45.6 billion into equities. They pulled $5.08 billion out of alternatives during the same period.

Perhaps more striking is the flow data for alternative strategies specifically designed to add ballast to portfolios in volatile or down markets. Morningstar's Volatility category saw $2.45 billion in inflows in the last two years, an encouraging sign that at least some investors are preparing for potential increased volatility ahead. But other strategies that reduce drawdown and perform relatively well in down markets—including managed futures, long-short equity, bear market funds and market neutral strategies—saw outflows indicating that many investors are skeptical about future market volatility or declines.

For advisors, it is incumbent to teach novice investors—particularly young clients who haven't experienced a full market cycle—that market calm in recent years was an anomaly, not the norm. Those clients will need help preparing for normal market volatility and the eventual bear market. If their portfolio is diversified and includes strategies that focus on downside protection, it may help them rest easier when the market isn't calm enough to lull them to sleep.

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About 361 Capital

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* Source: CBOE. Data through 12/31/2018. Historical data from 1990-2018.

** Source: Commonfund.

† Source: US News and World Report: https://money.usnews.com/investing/investing-101/articles/2018-02-07/stock-market-volatility

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