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Volatility returns

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Investors who experienced the unprecedented market volatility during the financial crisis of 2008-2009 were recently provided with a reminder of how unsettling these times can be. Against the backdrop of generally improving global economic conditions and the early signs of a return to "more normal" monetary policy for the world's main central banks, investors had become cautiously optimistic. However, if there was any chance for them to become complacent, it has quickly been eliminated as significant volatility has returned. When markets are volatile, it is natural for investors to be worried about the impact on their portfolios. In addition, when people are worried, they want to take action. However, it's important to recognize that sometimes the best course of action may be to do nothing at all. Taking advantage of professional advice and having a sound financial plan will help to keep emotional responses in check. Your financial advisor can place you in the best possible position to weather these market storms and even take advantage of any opportunities that may appear as the markets work their way back toward a more stable state.

Global markets

Market	Index	Recent High	Date of High	Subsequent Low	Date of Low	% Decline	Number of Trading Sessions
U.S.	S&P 500	2,872.87	26-Jan-18	2,581.00	8-Feb-18	-10.2%	9
Canada	S&P/TSX Composite	16,412.90	4-Jan-18	15,034.46	9-Feb-18	-8.4%	26
Germany	DAX	13,559.60	23-Jan-18	12,107.48	9-Feb-18	-10.7%	13
U.K.	FTSE	7,778.60	12-Jan-18	7,092.43	9-Feb-18	-8.8%	20
Japan	Nikkei	24,124.15	23-Jan-18	21,382.62	9-Feb-18	-11.4%	13
Hong Kong	Hang Seng	33,154.12	26-Jan-18	29,507.42	9-Feb-18	-11.0%	10

Source: Bloomberg

As can be seen in the accompanying table, the recent selloff in the markets has been very rapid. The breadth of the declines is underscored by the fact that no region has been immune to the weakening. The recent highs indicated in the table were all-time high closes for each market, with the exception of the Nikkei. Nevertheless, the closing level indicated for Japan's main index was the highest since November 14, 1991. As of this writing, a technical correction (generally viewed as a 10% decline from a recent high) has been reached in the U.S., Germany, Japan and Hong Kong. While this could change quickly, both Canada and the U.K. have avoided this kind of correction so far.

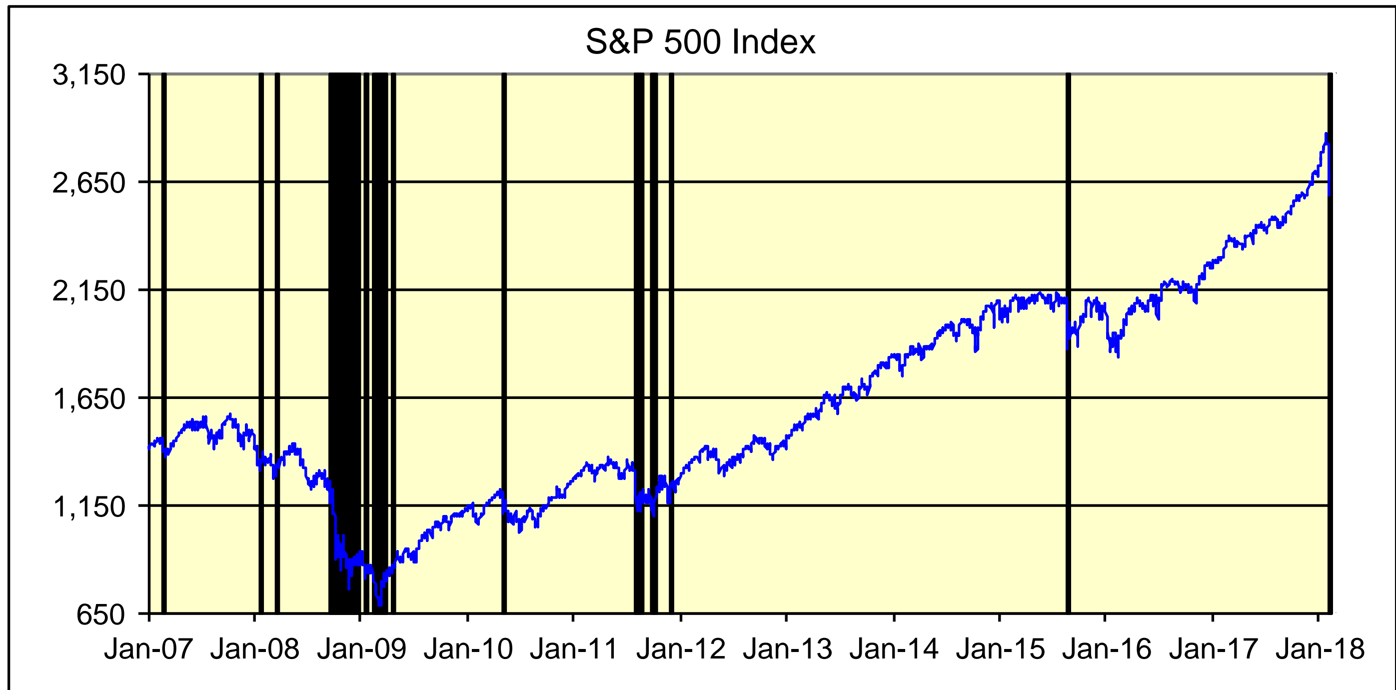
Looking at volatility

Source: Bloomberg

The financial crisis of 2008-2009 brought considerable focus on market volatility and news on the Chicago Board Options Exchange (CBOE) Volatility Index (VIX) was, seemingly, constant. The index is often referred to as the "investor fear gauge" and is constructed using the prices of a wide range of options (puts and calls) on the S&P 500 Index. The pricing of these options allows a calculation of an implied volatility, producing what is viewed as traders' expectations of 30-day volatility for the market. The index itself is relatively new. First introduced in 1993, the index was modified to its current form in 2003. The VIX graph above shows both the low levels of volatility experienced over the past two years and the very recent spike higher. However, even the most recent move and the move higher on August 24, 2015[1] fall well short of the extreme highs of the financial crisis. Another interesting development for this measure of market volatility has been the creation of ETFs that use the VIX as a reference "investment" either as a long position or as a short. Some of these ETFs compound their exposure by using leverage. The extended period of historically calm markets made betting against volatility (by using a "short" leveraged ETF) a very popular trade. However, the recent rapid surge in the VIX pushed the value of these instruments down sharply. In turn, as some of these investors sought liquidity to cover their dramatically weaker positions, they sold out of their equity holdings, exaggerating the moves in the equity indexes and raising volatility levels even further.

[1] A similar surge in volatility was seen on August 24, 2015 in the wake of a surprise devaluation of the Chinese yuan and oil's first decline below the US$40 level since 2009.

North American markets



Source: Bloomberg

Another way to assess the recent increase in volatility is by observing the markets directly. The graph above shows the U.S. S&P 500 Index (blue line) and days when the index experienced a 4.0% (or more) trading range[2] (marked by a solid black vertical line). The market would, on average, experience one session with a 4.0% trading range for every 100 trading days, or once every five months. Between September 15 and December 15, 2008, during the height of the financial crisis, the market experienced a 4.0% trading range on 43 of the 65 trading days. Historically, the Canadian market experienced one of these volatile trading days for every 69 trading sessions. However, that ratio also rose to 43:65 between September 15 and December 15, 2008. Volatility returned between August 4 and October 4, 2011, but the S&P/TSX Composite Index was somewhat less volatile than that of our southern neighbour, recording three sessions with a 4.0% trading range compared with nine for the S&P 500 Index. Both markets returned to narrower ranges over the subsequent years and a generally improving market tone saw both indexes move broadly higher. The spike higher in the VIX on August 24, 2015 was mirrored in both markets on August 24 and August 25 as both saw trading ranges wider than 4%. However, despite the fact that the U.S. market experienced these wide trading ranges again on February 5, 6 and 9, 2018, the Canadian market did not. Analysts suggest that Canada's experience with two outright bear markets [3] since the end of the financial crisis have kept equity valuations from becoming as stretched as they were in the U.S, which did not experience a bear market over this period.

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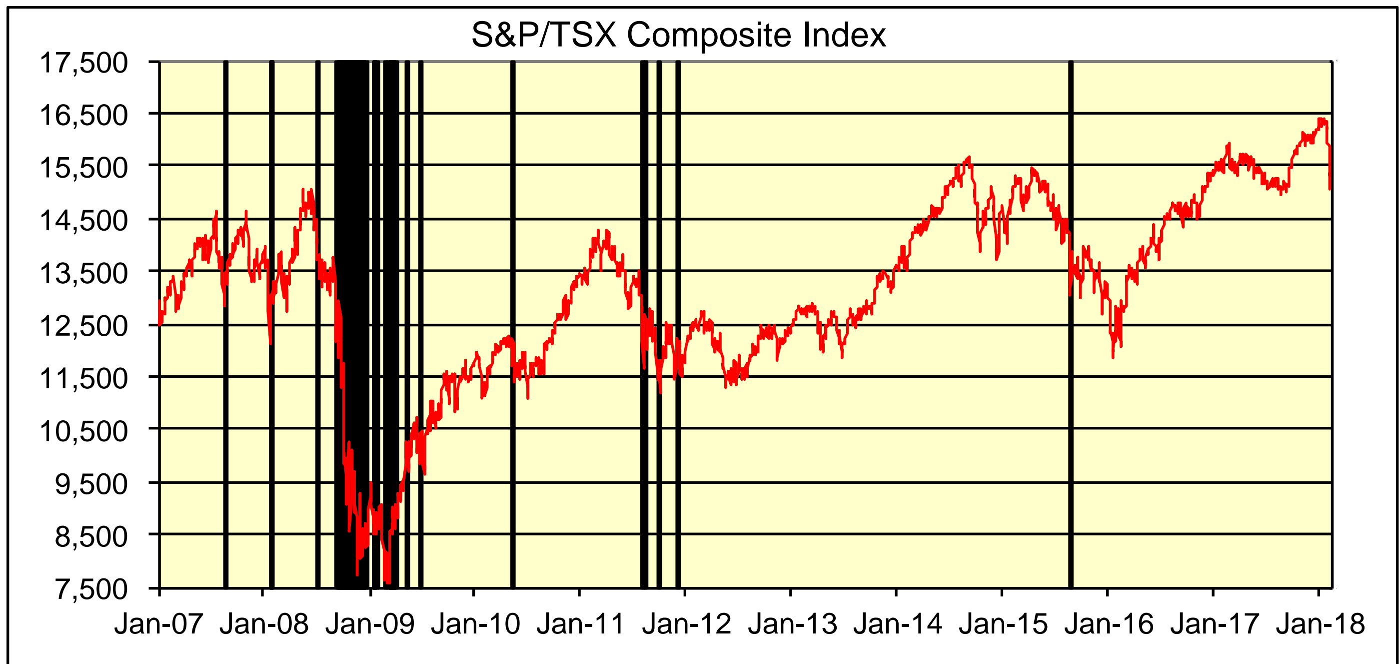
[2] A trading range is calculated by taking the difference between the "high" and "low" quote for the day and dividing it by the value of the previous day's closing level.
[3] A bear market is generally declared when a market index declines by 20% or more from a recent high.



Source: Bloomberg

What to do?

While it is not possible to be fully insulated from a market decline, there are effective wealth management strategies that can help investors prosper over the long term.

1. Take a long-term view

Any sharp decline in the stock market is often accompanied by dire headlines in the media, often using words like "crisis" or "meltdown." It is the job of the media to sell its stories, and negative news sells. Although this type of reporting fosters a climate of urgency and fear, the fact is that volatility is a normal part of investing. However, even though market volatility is not unusual, it can be unsettling. That's why it is also important to remember that market declines have been followed by even greater recoveries. The fact remains that both the S&P/TSX Composite Index and the S&P 500 Index did recover from the financial crisis. For both of these markets, every correction and bear market has been followed by a recovery. In other words, the stock market moves in short-term cycles but the long-term trend is up. Both of these indexes reached all-time highs as recently as January. But to reach these highs, investors had to travel through peaks and valleys. One defense against market volatility is to try to also put the daily news into a long-term perspective. Despite the crisis reporting, we know that recessions end, that businesses continue to operate, and that economies and markets recover and grow.

2. Be diversified

Diversification is a key principle in investing, and it refers to the practice of spreading investments among the different asset classes: stocks, bonds and cash. These broad asset classes can be further subdivided – stocks, for example, should include Canadian, U.S. and international stocks, as well as large and small company stocks. Why is diversification important? Each asset class performs differently as market and economic conditions change, and there is no way to predict which one will be the leader. The chart below shows how the returns and the ranking of each asset class have varied dramatically since 2000.

Return: U.S. Equities; U.S. Small Cap; Canadian Equities; Canadian Bonds; Emerging Market Equities; International Equities; Canadian Small Cap

Sector Performance	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Best	10.3%	8.8%	8.7%	34.4%	16.8%	31.2%	21.8%	19.7%	6.4%	62.4%	35.1%	9.7%	16.1%	48.4%	24.0%	21.0%	38.5%	28.7%
	7.4%	8.1%	-3.5%	27.8%	14.5%	24.1%	21.3%	9.8%	-17.9%	35.1%	31.1%	4.4%	15.3%	41.5%	14.4%	18.8%	21.1%	17.4%
	4.7%	4.2%	-7.0%	26.7%	12.4%	10.6%	14.9%	3.7%	-21.9%	53.0%	26.0%	-2.0%	13.8%	31.8%	10.3%	14.0%	17.7%	13.8%
	0.8%	3.8%	-12.4%	20.5%	10.2%	10.5%	11.6%	0.9%	-29.4%	13.2%	14.5%	-8.7%	13.5%	13.0%	8.8%	3.5%	8.6%	9.1%
	-5.5%	-6.5%	-16.4%	13.9%	6.5%	6.5%	10.6%	-5.3%	-33.0%	8.7%	8.7%	-9.7%	7.2%	7.6%	7.1%	1.9%	8.3%	7.1%
	-10.6%	-12.6%	-21.1%	6.7%	7.2%	1.6%	10.6%	-10.6%	-41.4%	8.1%	7.9%	-16.3%	3.6%	4.5%	4.2%	-8.3%	1.7%	2.8%
Worst	-28.2%	-16.4%	-22.7%	5.3%	3.3%	1.3%	4.7%	-16.5%	-45.5%	5.4%	6.7%	-16.4%	-2.2%	-1.2%	-2.3%	-13.3%	-1.5%	2.5%

Source: TD Newcrest, Morningstar   This chart shows calendar year returns for seven broad-based asset classes (in Canadian dollars).

Canadian Bonds – TMX Universe Bond Total Return Index
International Equities – MSCI EAFE Index ($CDN)
Canadian Equities – S&P/TSX Composite Index Total Return
U.S. Small Cap – Russell 2000 Index ($CDN)
U.S. Equities – S&P 500 Composite Index Total Return ($CDN)
Canadian Small Cap – S&P/TSX Small Cap Index Total Return
Emerging Market Equities – MSCI Emerging Markets Free Index ($CDN)

A diversified portfolio will have much more stable returns by having reduced exposure to any one asset class. The process of determining a portfolio's asset mix is called strategic asset allocation. This recognizes that different asset classes have different risk-return profiles. Most investor portfolios will include some bonds or bond funds, which offer stability but relatively lower long-term returns, and some equities or equity funds, which are more volatile in the short term but have higher long-term returns. With the help of a financial advisor, the asset allocation is tailored to the investor and while adjustments are likely to be necessary over the life of the portfolio, changing the asset allocation in response to short-term changes in the markets will likely do more harm than good.

3. Resist the temptation of market timing

In a perfect world, an investor would be able to sell out of the market just before it declines and re-invest just as it is poised to recover. Of course, this strategy of timing the market is impossible to put into practice. There's an old Wall Street saying: "Nobody rings a bell at the top of the market and nobody rings one at the bottom." Often, investor fears drive them to sell low, after the market has already dropped, and then buy high, once the subsequent recovery is well underway. Historically, there have been no indicators that consistently predicted the direction of the market. Even the economy is not a reliable predictor, because the stock market often rebounds months before an economic recovery is evident. Furthermore, when the market does recover, its gains often come in bursts. Missing those few days or months of strong returns can have a huge impact. During the financial crisis, the S&P 500 Index bottomed on March 9, 2009. Not including the dividends that would have been paid to the actual stock owners, the index has increased by an annualized 16.4% – including the period of recent volatility – since then. This means that $10,000 invested over that period would have grown to $28,720. Over that time, there have been seven trading sessions where the index has recorded a return of 4% or more. If an investor had been out of the market just for those few days, their return would have been 11.9% and their investment would have grown to a far less impressive $17,370. In other words, staying invested can be the best strategy.

4. Take advantage of market volatility

It seems counter-intuitive to view a declining market as a "good" thing. But some investors do. Given the stock market's long-term rising trend, market declines have been an opportunity for long-term investors to buy stocks at lower prices. It's as if stocks are on sale. This is the thought behind this statement by Warren Buffet, one of the world's greatest investors: "Be fearful when others are greedy and be greedy when others are fearful." Of course, not everyone has billions of dollars like Warren Buffet. But there are tried and true strategies that anyone can use to take advantage of market volatility.

Dollar cost averaging
Dollar cost averaging refers to the practice of investing a fixed amount of money at regular intervals, regardless of market moves. The result is that investors buy more units when prices are falling and fewer units when prices are rising. In volatile markets, this practice tends to lower the average cost of investments. Dollar cost averaging does not protect against a market decline, but it is an easy, disciplined investment strategy that's been proven to pay off over the long term.

Rebalancing
Rebalancing is the practice of selling asset classes that have performed well and reinvesting in those asset classes that have underperformed. It is the process used to maintain a target asset allocation. Take, for example, a simplistic asset allocation of 60% equities and 40% bonds. After a good year on the stock market, the equity portion of the portfolio has increased to 68%. The portfolio would be rebalanced by selling 8% of the equities – taking profits – and reinvesting them in bonds. This restores the asset allocation to the 60/40 target. In general, rebalancing ensures that a portfolio remains true to the desired risk profile, smooths out returns, and is another disciplined way to ensure "buying low and selling high."

5. Invest with an advisor

The financial markets can present daunting challenges for even the most seasoned investor. A financial advisor can assist in determining financial goals and the development of an investment plan. Taking advantage of this professional advice can lead to reduced anxiety in the face of market turmoil and the negative news that accompanies it. Further, investors can avoid many common mistakes that typically reduce long-term investment success. Poor diversification, attempting to time the markets and exiting the market at times of uncertainty can be avoided. A well-thought-out financial plan will match an investor's individual needs, including an appropriate asset allocation and proper rebalancing. The support of a financial advisor can help instill the investment discipline needed to make regular investment contributions, particularly in challenging times. Well-advised investors will find themselves positioned to benefit from the inevitable recovery.

Conclusions

- While they can represent a significant challenge to investors, heightened volatility and the accompanying news stories, are a normal part of evolving financial markets.
- Episodes of elevated volatility can easily prompt an emotional response and a desire to exit the market. Having an advisor can help investors to avoid acting on their emotions.
- Taking advantage of professional advice and establishing a financial plan will help ensure a disciplined approach to investing.
- Periods of market uncertainty can mask opportunities that will be missed by investors who go to the sidelines during these times.

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