The Rocky Stock Market

Intro

The stock market has been grabbing a lot of headlines over the last few months. This month, we explain the stock market's recent volatility and put it into perspective.

This Year

First, let’s review what the U.S. stock market has been doing this year

You may recall that just 11 months ago we were told about the “best January in decades” when stocks were up more than 5% for the month. How things change in short time periods. It is now looking like the U.S. stock market will struggle to achieve merely a positive return for the year. International markets have also struggled this year, giving up about half of their 2017 gains (at the time of this writing) with much of it due to the added volatility of fluctuating currencies.

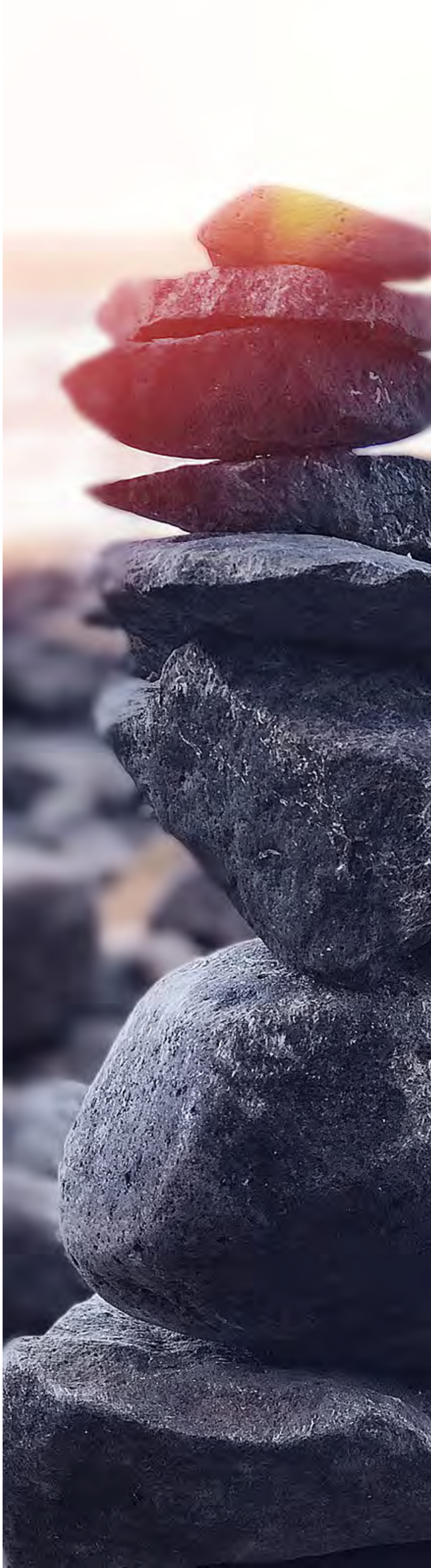
When we see the stock market’s abrupt moves, how should we think about them? Any abrupt move, whether it’s something in a bush when we’re walking, or in a report about the day’s business and stock markets, tends to trigger our innate response for “fight or flight.” Heart rates increase and foreheads wrinkle, especially if the newscast presents the story with its unique authoritative and immediate call to listen. The way we should think about this, as with most abrupt moves, is to put it in perspective.

Last Year

Last year (2017) was one of the quietest, smoothest markets on record.

Its lack of movement grabbed several headlines throughout the year. This year, volatility has actually returned to its normal state. Stocks are volatile by their nature. They are traded every business day (or just about every day, globally) and they are constantly absorbing news and information. The average daily movement in the stock market is about 0.67%, or about two-thirds of one percent. Since the Dow Industrials index is at about 24,000 that translates to a typical day's move of about 166 points, either up or down.

That 166 points may sound like a lot since the Dow index has been steadily increasing over the decades, but 166 points isn't the same as it was 10 years ago, when the Dow was at about 10,000 (and a 0.67% move was 67 points).

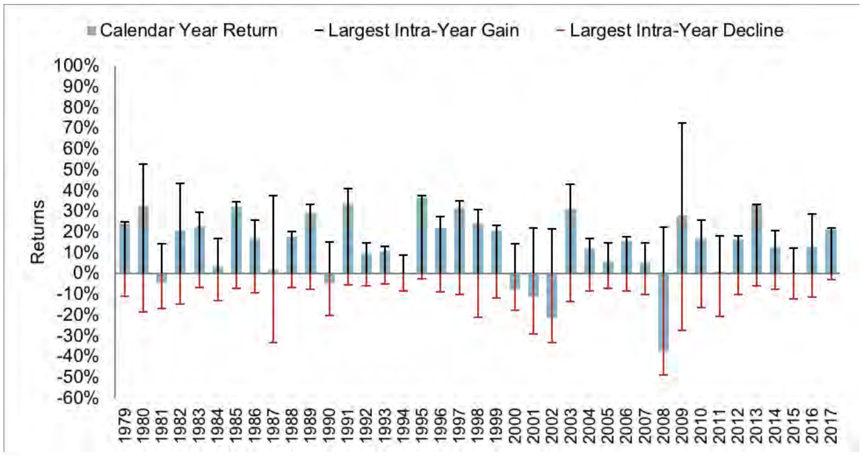


The year before that, and the year before that, and...

Now let's look longer-term.

The chart below shows the annual performance of a broad benchmark, the Russell 3000, since 1979. This benchmark represents most of the stocks in the U.S. The blue bars show each calendar year's total return. The lines show each year's largest gain and decline. Notice that the far right bar is 2017 and the lines follow the bar's performance very closely. Compare that to 2009, where the gain and loss is almost three times the length of the blue bar. Or, for another extreme, look at 1987 (the year of "Black Friday").

The year 2017 had historically low volatility and 2009 had very high volatility. Keeping those lines in mind, now look at the other years. Is there a repeated pattern? No, but we can get an idea of what "normal" volatility looks like and how easy 2017 was.



Next Year

What does increased volatility mean?

Could it be that this increased volatility is the result of greater uncertainty and therefore presages a market top or bottom, or an economic recession or expansion? If only it could, but once again, nothing is that simple in our complex, global economy. We just cannot predict the future.

We do know this: eventually the market will sense a slowing economy is approaching and it will react negatively. Whether now is the time it's reacting accurately for the longer term, we can’t say. There is too much noise to decipher any important signal in the short-term.

When we do have a recession, it’s important to keep in mind that some of the stock market’s best days occur during a recession. Just as the market will eventually sense a slowing economy, it will also recognize an expansion in advance. If we knew when these would occur, we would all be lying on beaches somewhere sunny whenever we please. Unfortunately, that isn’t the case and research shows that because we don’t know those times, we should stay invested for the long-term.

Research shows that volatility is not an accurate predictor of the stock market's future performance. We do know that volatility usually increases after a decline in stock prices. When stock prices drop, stocks’ long-term future return prospects improve.

What if?

So, given what we know, can we build an investment strategy to take advantage of volatility by avoiding the stock market when volatility spikes?

What if we had a trading strategy that "flies to safety" by:

- Investing in Treasury bills whenever the previous month's volatility was high (75^{th} percentile or higher), and
- Investing in U.S. stocks if the previous month's volatility was not high.

Over the period from January 1927 through April 2016 the volatility of our strategy would have been about 40% lower than if we had stayed completely invested in stocks (as measured by the returns' standard deviation). But our returns would also have been significantly lower with our fly-to-safety strategy returning about 8% per year versus the stay-invested-in-stocks strategy of almost 10% per year.*

Volatility is one of the reasons that stock market returns tend to be higher than some other investments. It's the price we pay in order to increase our probability of achieving higher returns over long time periods. In investments where volatility is lower, such as bonds, returns tend to be lower.

So, once again our job is to balance stocks and other investments in order to arrive at the allocation that is right for you. One that "keeps you in your seat" when markets get rough while also achieving the returns you need to fulfill you financial goals.

Thanks

We hope this is helpful, and we certainly wish everyone the Happiest of New Years. We look forward to seeing and hearing from you.

Thank you for your trust.

Your Vista Wealth Management Team

*Calculations provided by DFA using data from Fama/French and Morningstar.

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