CLIENT'S CORNER

Volatility: The October Tutorial

On September 18, for perhaps the two dozenth time this year, the broad equity market in the United States, as measured by the Standard & Poor's 500-Stock Index, made a new record closing high at 2,011. (I'm going to be rounding here, because the larger point is so much more important than pedantic precision.)

It tailed off a bit in the following three weeks or so, but—on some news or other about monetary stimulus in Japan, if memory serves—rallied to close on October 8 at 1,987. So far so good.

One week later, on October 15—we're talking just five more trading days—it was, for a few minutes, as low as 1,820, down nearly eight percent in a week. It closed that day at 1,863, rallying strongly off what turned out to be the panic bottom of this particular setback, and then vaulted yet again into new high ground at 2,018 on Halloween.

It doesn't often do that.

Oh, I don't mean it doesn't often go down eight or ten percent, or whatever. It does that and more literally all the time, as we shall observe in a moment. No, what I'm saying is that it doesn't often go from new all-time highs through a terrifying episode of sheer, mindless panic to still higher new highs in six weeks, with the huge preponderance of the decline compressed into just one of those weeks.

Thus, on those rare occasions when we get an event like this—a complete mini-tutorial on volatility, so to speak—we should treat it with respect, and spend some serious time and energy trying to discern what it tells us about the larger market cycle—and, even more importantly, about ourselves.

The details of the tripartite "crises" which constituted this year's October surprise need not concern us to any great extent. In no particular order, they were (a) ISIS, (b) Ebola, and (c) the sudden rediscovery that the eurozone is a moribund economy, which put persons of a certain age in mind of the iconic Saturday Night Live news headline: "Our top story tonight: General Francisco Franco is still dead."

It's always something. And I mean that quite literally, inasmuch as, since 1980, the ***average*** intra-year decline in the S&P 500 has been fourteen percent. Let me say that another way, to make sure there's no room for misunderstanding: **14%**. This year's peak to trough decline of about half that was a piker, a blip, a veritable sunshower in the great tapestry of volatility—that is, in the ongoing epic of a permanent advance in the values and dividends of companies, punctuated from time to time by temporary declines in their stock prices. It's just that this year, you got to watch the whole movie in six weeks.

And that last variable—six weeks—is your doorway into a potential understanding of the evanescence of volatility. Consider this exercise: take a moment now, and write down the names of ten great companies with whom you might do business, or whose products you might be using, on any given day. (Hint: what brands of food do you ordinarily buy, where do you gas up your car, who made your laptop or mobile device, who provides your internet and/or phone service, from whom do you order books, where did you buy the clothes you're wearing, where do you bank, who produced the movie you saw this weekend, *et cetera*?)

Now ask yourself this critically important question: granting that the prices of these companies' stocks might have been down (if only for a few minutes) ten percent in the month to October 15, ***did it seem probable to you that the values of the companies themselves, as operating businesses, had been permanently diminished by ten percent?***

If it didn't, good for you, say I. First, because you intuit that, human nature and especially mass psychology being what they are, the prices of stocks tend to be much more volatile than the values of companies. That's a critical distinction, and one that most investors seem incapable of grasping—which goes a long way toward explaining why most investors don't succeed.

Second, because you seem to have looked at October's five-day mini-Armageddon and concluded not "This time it's different" but "This too shall pass." And so it rather quickly did. More to the point: ***so it historically always has***. That was precisely the lesson of the tutorial. That's what it was trying to remind you—against the day when we get a real crisis and a real market decline worthy of the name.

If, on the other hand, you took the "crises" seriously—if you thought that what you were watching might be a lasting diminution in the values of great global businesses—and if, heaven forbid, you reduced your long-term equity holdings…well, the tutorial may yet prove to have been a salutary experience for you, too. Not one you'd ever want to repeat, certainly, but one which you can now take into every succeeding episode of volatility which you will surely experience in the years to come.

Reduced to its essence, that lesson is only marginally about equities, as their prices alternately soar and swoon around the rising long-term trendline of their values. It's much more about you, and about the way you process the experience of normal (and even necessary) volatility. Simply stated: **if you can't persevere through a fifteen percent decline pretty much every year—and maybe twice that about one year in six—then you just flat-out can't ever be an equity investor.**

As a friend—and there's no doubt that your financial advisor will wholeheartedly concur—I urge you to embrace this truth before another year begins. Either accept equity volatility for what it is—relying on your advisor to coach you through it—or find something else to invest in. But for heaven's sake, don't come into equities when they're doing fine, only to flee them in "crisis." Because that's not just a formula for underperforming the markets. It's a formula for underperforming ***your own investments.***

© December 2014 Nick Murray. All rights reserved. Reprinted by permission.