



Out of the



Blue

Market volatility is like in-flight turbulence—nerve-racking even when it isn't dangerous.

BY VANESSA DRUCKER

Turbulence on the ground doesn't have to be an earthquake or a tsunami. Consider the tumultuous stretch from August 8 through August 16, 2007, when the Dow Jones Industrial Average plummeted 1,313 points. Like a row of dominoes, PNB Paribas, the largest bank in France, announced it was suspending redemptions on three funds, while central banks around the world injected cash infusions to staunch the hemorrhaging. The European Central Bank loaned out \$131 billion—more than it had added the day after Sept. 11, 2001.



And then the investors began panicking.

On that fateful August 16, Scott Mosley called his 15 top clients. Mosley, the owner of Cimarron Capital Consulting, a boutique investment management firm outside Austin, Texas, told his anxious flock that yes, their portfolios had indeed sustained losses, and that he anticipated several more days of volatility. “The crisis appears to be contained,” he told them, and fortunately, they deferred to his judgment.

Whether it makes investors giddy or queasy, volatility is a fact of financial life. Since good planners maintain ongoing conversations with clients in both good times and bad to remind them to expect both upside and downside fluctuations, it certainly helps to know what causes volatility and whether there is any way to ride out the worst of it.

What Creates Volatility?

Because volatility often strikes with little warning, it is easier to identify its sources in retrospect. Inflection points—from a

phase of pure growth to one of retrenchment—create uncertainty, as investors are still unsure whether the new phase has yet begun. Each new piece of data is taken as evidence, either by the growth camp or its retrenchment counterpart. “People don’t know how to interpret the direction from the noise, which turns into a tug of war between the two sides,” explains Collin Crossover, the London-based head of currency management for State Street Global Advisors.

A typical example occurred on Oct. 5, 2007, when non-farm payrolls rose by an unexpected 110,000 jobs—with upward revisions to the prior month’s tally. By the time the market closed, the DJIA had vaulted 97 points. Yet it would have been equally possible to construct a logical case that the market should be tanking, since there would be less chance the Federal Reserve might trim interest rates, especially since hourly earnings rose an inflationary 1.4 percent. At that moment, the rate cut that most observers were anticipating suddenly looked less sure. So why was the market going through the roof? Perhaps it was behaving in an illogical way because it was reaching an inflection point.

While October may indeed have represented an inflection point, Peter Cohan, who teaches management at Babson College in Wellesley, Mass., offers a more cynical view. “Markets move up and down for reasons explicitly hidden from the public,” he says. “Large volume traders do not explain to the media their decisions to buy or sell.” An investment firm may give a reporter some rationale, which creates an illusion of logic—but it may not be the real spur behind the big volume trades. Cohan, who also runs a venture capital firm for high-tech start-ups, adds dryly, “It is some psychological process of transference that makes many people believe they need a financial planner who may possess extra wisdom they don’t have.”

As investors egg each other on with a herd mentality, both noise and mistakes become compounded. They are all reading the same newspapers and watching the same analyses on television. Even a fairly insignificant item, such as a single analyst’s sell recommendation, may cause a disproportionate reaction.

Black Swans

Anything that is unpredictable can affect the value of investments. Cohan divides the possibilities into two classes. First, he cites those events that are bound to occur, “and won’t come as a complete shock.” For example, foreign exchange levels and interest rates will surely change, and economic growth rises and falls. Certain countries wax and wane, in terms of their relative influence in the global economy—like the once predominant British Empire and the current emergence of “Chindia.”

On the other hand, some catalysts cannot be predicted, such as the overwhelming dominance of Google or the shock of 9/11. Cohan tips his hat to the so-called “Black Swan” concept, proposed by Nicholas Taleb, as a highly improbable event, outside normal expectations. “Fifteen years ago, newspapers could not have predicted that Silicon Valley would take away their ad revenues,” Cohan says.

These two classes hold different implications for investors, and differences in how they should treat volatility. At what point, Cohan asks, does something go “from the primordial soup of unpredictability” to becoming a viable bet? In 2000, it was still an open issue, but over the past four years

it has become evident that the U.S. government is pursuing a weak dollar policy and China is pouring investment into infrastructure. As a real trend emerges from the soup, investors can make active bets on the declining dollar as they seek strength in the global economy.

Until the direction becomes settled, the average investor would be better advised to avoid individual trades, and instead buy an index or money market fund to hedge the unpredictability. It makes more sense to bide time in a diversified vehicle, like an index, until the volatility transforms itself into a discernible pattern. Of course, the challenge is that markets often move only when investors change their beliefs about fundamentals, which may not be when those fundamentals move. Technology began to propel the U.S. economy in the early 1980s, for instance, but most investors failed to recognize the paradigm until it was well under way.

Another strategy is to hedge against hiccups. Michael Cohn, who runs Atlantis Asset Management from New York City, writes covered calls on his clients’ diversified stock

holdings. Those options generate income, which he uses to buy S&P puts at about 3 to 4 percent below the market, as insurance, “to take out the disastrous months.” It is true that his strategy produces small losses if the market goes up in a straight line, and his upside will be capped in some stocks—especially if a takeover causes a sudden vault. But it does offer protection. “The beauty of options is that you can play them from both sides and benefit from the volatility,” says Cohn.

The Plan

Advance preparation—sitting down and drafting an investment plan with each client—remains the best defense against market vagaries. “It sounds basic, but few investors actually create a plan that will guide them through volatile times,” reports William Keller, director of investments for PNC Wealth Management in the Baltimore-Washington, D.C. area. He contemplates several items before putting the first dollar to work: an individual’s time horizon, liquidity needs, tax situation and legal status—such as trusts.

The most important factor is risk, rather than returns. Typically, clients will seek certain levels of return and will then calibrate the degree of risk they are prepared to under-

take. The problem with that approach, says Keller, is that risk propensity is difficult to quantify. When the sun is shining, and the markets are booming, most people become less risk averse. In his opinion, it is more realistic to spin the risk/return relationship around by 180 degrees. Start by assessing a client's underlying needs in order to calculate a level of acceptable risk. Using that measure of volatility, you can then quantify how much return to expect.

When a client tells a planner that he or she expects a specific return, the planner must take risk to achieve that. That means disappointing the investor from day one. "You would not tell a doctor, 'I expect to feel better on such and such a date'. You say, 'Here are my symptoms', and the doctor prescribes," Keller explains.

Once the plan is drafted, it's time to put the money to work. Statistics show how hard it is to time the market, and many studies have explored the consequences of missing the "10 best days" during a given period. Suppose that you missed the 10 best days from 1985 to 2006, a time that equates to a total of 5,297 trading days. During those years, the market returned an average of 12.12 percent. Those unfortunate souls who were not invested for the 10 bumper days only received 8.56 percent, while those who were out on the best 40 days earned only 1.87 percent. Missing the best 70 days produced a *negative* return of 3.02 percent.

Suppose your client has received an inheritance, a rollover

from a pension plan, or sold a business? Are substantial funds suddenly available? "The key is not to delay the plan," according to Tom Wilson, managing director of institutional investments at Brinker Capital in Berwyn, Pa. In less volatile environments, he deploys all new assets at once. For those clients who are more concerned about volatility, he usually invests one-third of the equity allocation immediately, and the remaining two-thirds over one to three months—not two to three years. "You don't want to be out that long," Wilson says. "Ironically, the stock market is one of the few places where people feel more comfortable buying at higher prices!"

Upside volatility can also create dangers. When particular sectors flourish, people tend to chase them—often at the worst times. In recent years, emerging markets have experienced outsized returns, and hence are seeing more flows. Even if you are bullish on the long-term trend, stick to the allocation plan and rebalance, especially if allocating fresh funds. Remember that REITs, once a sleepy asset class, also began to garner huge flows—until they plunged 10 percent in the second quarter of 2007.

Selling into volatility is a harder choice. Where will the money go? The discussion will vary, depending on whether it involves a particular stock or an entire asset class. If a portfolio is committed to equities, and you believe the asset class is appropriate for the long term, you cannot exit the entire

THE LONG VIEW

Looking back 150 years, a debate has raged in econometrics over the source of market volatility, and whether there exists a statistically significant relationship with downward economic trends. During the period between the wars—1917 to 1939—it does appear that worldwide depressions and rapidly declining economic conditions were reflected in capital market angst. "It was chicken and egg," says Scott Mosley of Cimarron Capital Consulting near Austin, Texas. "Fear, generated from economic and political events and crises, was closely tied to volatility."

It is interesting that post 1945, those trends became less significant. In general, macroeconomic volatility—as measured by GDP—has declined, but in capital markets, it has increased.

Since the 1970s, capital market innovations have acted to stabilize business and credit cycles. Structured products helped to disintermediate capital distribution away from banks. "Stocks, bonds and currencies now function as shock absorbers, so the real economy can adjust more slowly and with fewer dislocations," says Marc Chandler, chief global currency strategist at Brown Brothers Harriman.

Yet developments in financial engineering have also exacerbated volatility. Leverage, exotic strategies, structured products and derivatives in every form have amplified the fluctuations. Consider the ABX index, a series of credit default swaps based on bonds that comprise subprime mortgages. The credit market rout became a vicious cycle last summer, as notional amounts of speculative trading in the indices surpassed the aggregate volume of the underlying instruments. Says Mark Adelson, a New York-based securitization consultant, "The market could have remained more orderly had derivatives never entered the scene." —VD



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averse. Robert Quinn, senior vice president at Boston Private Bank and Trust, cites venture capitalists, “who get plenty of risk from their venture deals,” and commercial real estate operators, “who have seen enough cycles to be conservative.” They may even want to keep all their assets in fixed income, yet become stressed when the values of the bonds fluctuate. Quinn can actually reduce the volatility of their portfolios by just moving 20 percent or 30 percent to equities.

Honesty is the best policy. A candid and realistic perspective may sound bearish at times, compared to the optimism of a “flashier” advisor, says Wilson. He notes, however, that wealthy clients, who seek to preserve capital, appreciate an honest approach. In any case, those clients who are constantly chasing returns tend to be fickle, and the ones who are most ready to switch advisors. “They are a more difficult book of business to manage,” Wilson points out.

The principles for managing expectations are to “avoid surprises and maintain a high level of contact,” Quinn recommends. Ask questions, educate clients to understand that a long term process is involved and emphasize that periods of market declines will occur. Try to create a happy medium with a cash cushion for those eager to bail in turbulent times. Focus on increasing or maintaining an adequate income stream, and stick to the allocation plan with discipline.

Vanessa Drucker, who used to practice law on Wall Street, wrote about Americans living abroad in December’s *Wealth Manager*.

asset class without breaking the cardinal rule. Otherwise you will be selling low and waiting for the markets to recover before buying back in.

When dealing with individual holdings, Keller adopts a different strategy. “It takes the emotion out, to put up a high and low range, with fundamental trigger points,” he suggests. He tends to use a 20 percent rule for selling a position that declines below that level, although he is less inclined to favor stop losses, which often get whipsawed on volatility.

The Pain Threshold

In their work, behavioral psychologists Amos Tversky and Nobel Prize-winner Daniel Kahneman have persuasively demonstrated the force of loss aversion: Investors feel more pain in taking losses than pleasure in reaping gains. Reactions to negative returns are more heightened than reactions to positive ones, and watching a portfolio tumble for a couple of months is frightening to an investor. While you may understand intellectually that the portfolio will recover, when it is your dollar it becomes more than an intellectual exercise. “Most people claim they have a long-term outlook, but it soon goes out the window,” says Mosley.

During those times, he finds it helpful to demonstrate the dual nature of volatility—both upward and downward from the average. He finds that a graph of the VIX is a useful tool to show how a specific portfolio has behaved historically when overlaid with the volatility measure.

The VIX, published by the Chicago Board of Options, represents the implied volatility of the S&P 500, and serves as a proxy for the ups and downs of the broader market. The graphs of an older version of the VIX show a surge in volatility in 1990, followed by a calm era through 1997. After the ruble default and Long Term Capital Management crisis in 1998, it spiked to 44.2, its highest peak ever. Climbing to the mid-40s in 2001 and 2002, the VIX retreated again, until recently. It began to climb in July 2007 and shot up to a multi-year high of 30.83 on August 16.

A 24- or 36-month standard deviation shows trends over time even better. When investors see the graph, they can intuitively grasp how the events of the broader market are affecting their own portfolios.

Of course, clients differ in terms of their goals, psychology and financial experience. Younger professionals are less likely to be affected by standard deviation. Older investors tend to be more focused on legacy issues and to use inflation as their benchmark. Some clients will turn out to be surprisingly risk