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OUTSIDE THE FLAGS

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Are We There Yet?

The twists and turns of financial markets in the opening weeks of 2016 have left many investors feeling like victims of car sickness. So what's driving the volatility, how unusual is it and what can you do about it?

Volatility is not unusual at times of heightened uncertainty. Some of the issues cited as unsettling markets recently have been doubts about the extent and impact of China's slowdown, steep declines in oil prices and what all this might mean for the path of US interest rates this year.

But such external events are not the only things that influence prices. Markets can also move based on investors' own changing tastes, preferences and risk appetites. None of these variables are constant.

The key point is that expectations about the global economy, company profits, interest rates and other indicators constantly change on new information. And those changes are reflected in the prices of securities.

Indeed, if prices didn't change at all based on news, there really *would* be cause for worry because it would raise questions about whether markets were working effectively.

So are the recent market moves out of the ordinary and do they necessarily point to further price declines? Let's look at the data...

The world's biggest stock market did have a particularly poor start to the year. In fact, as measured by the benchmark S&P-500 index, the US market suffered its ninth worst January since records began in 1926.

Does this mean it is on course for a down year? Not necessarily. In the US market over the past 90 years, a negative January has been followed by a *positive* performance for the rest of the year 59% of the time.

What about the Australian market? It's true that the S&P/ASX 300 total return index fell 3.2% in January, but that is nowhere near its worst start to the year. In the first month of 2008, for instance, it fell 11%. In 1981, it fell 7.7%.

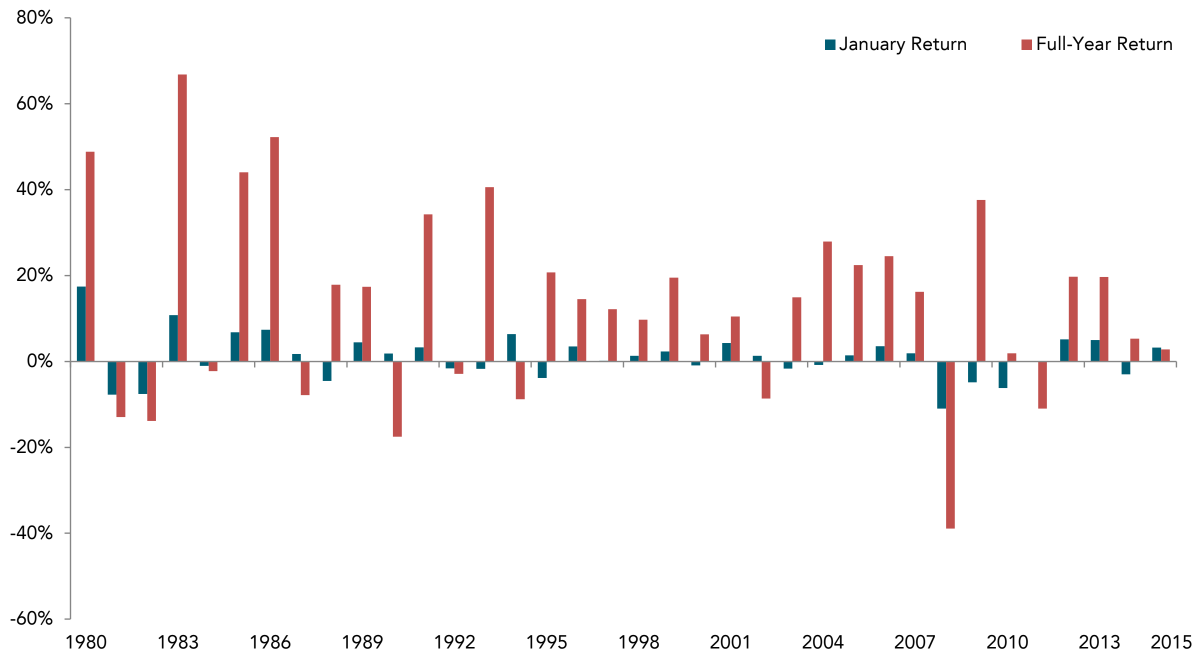
While Australian data only goes back to 1980, there is also no clear pattern here between January and full-year performance. A negative start in 1993, for example, was followed by a full-year return that year of more than 40%.

In more recent years, who can forget the early months of 2009 during the peak of the global financial crisis? The Australian market started the year with a fall of nearly 5% yet by the end of that year was up by more than 37%!

The chart below shows that of the past 36 years back to 1980, the Australian market has risen in 26 years and fallen in 10. While the return in January has been negative 14 times, in nine of those the market ended up for the year.

This isn't to predict that we're on course for a similar turnaround in 2016, but it does serve as a reminder about the danger of drawing inferences about future market direction from what has happened in the immediate past.

Chart1 **AUSTRALIAN SHAREMARKET:** (S&P/ASX 300 Total Return Index - 1980-2015)



Source: S&P

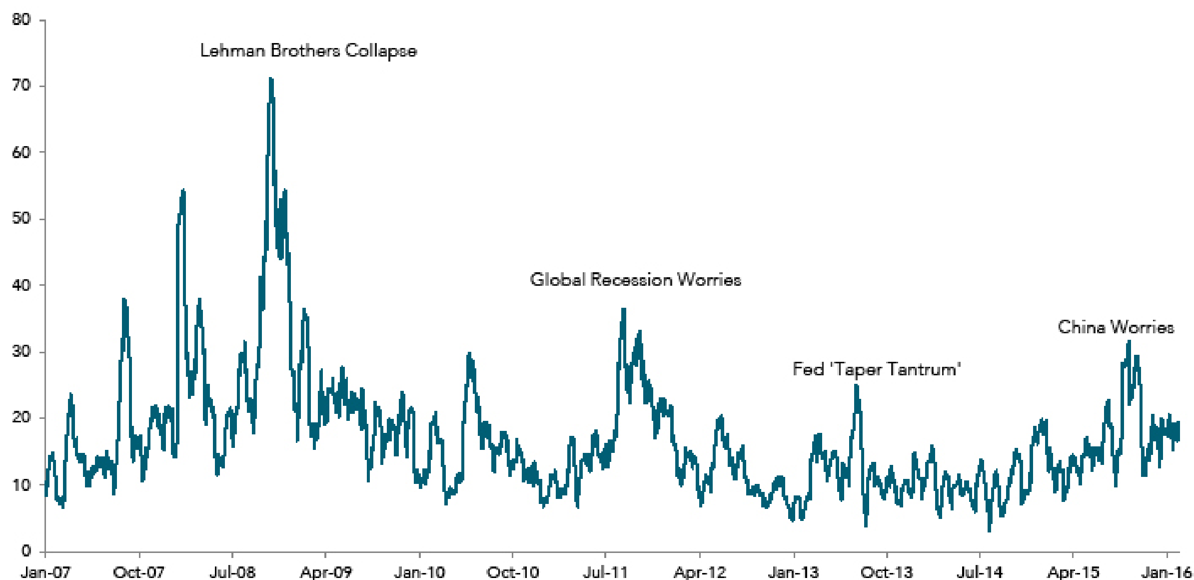
How about the pattern of recent volatility? Every day, it seems, we hear on the morning radio news of a big fall on Wall Street, only to be told of a similarly spectacular rebound a day or two later.

The truth, however, is the recent bout of volatility has not been exceptional. In the US market, a common measure of equity volatility is the 'VIX' index. This jumped to around 27 in January from the mid-teens late last year. (A higher number means more volatility).

But that is still only about half of the levels of August to September last year when China devalued its currency, in mid-2013 at the time of the so-called Fed "taper tantrum" and again in in mid-2011 when global recession fears were intensifying. And it is virtually a quarter of the peak levels the VIX reached when Lehman Brothers collapsed in October 2008.

Similarly, in Australia, volatility has risen this year, but it is well short of the levels experienced in the GFC. Chart 2 below shows the S&P/ASX-300 index as measured by historical volatility on a 15-day rolling basis.

Chart2 AUSTRALIAN MARKET HISTORICAL VOLATILITY: (S&P/ASX 300 Accumulation Index - Rolling 15- Day)



Source: Bloomberg

So what lessons can be drawn here? And more importantly, what can you as an individual investor do about the volatility?

- First, there is no hiding from the fact that for many investors market volatility can be unsettling. But we have seen that extrapolating past market moves into the future is not a reliable strategy.
- Second, prices move on news. Unless you have the extraordinary and unheard of ability to anticipate news, you can't predict with any consistency what markets will do next.
- Third, while you can never fully escape volatility, you can moderate the ups and downs by diversifying across different asset classes (stocks, bonds, property and cash) and within asset classes.
- Fourth, what ultimately matters is not your ability to second-guess short-term market moves, but how your portfolio is travelling relative to your own stated goals, risk preferences and investment horizon.

If you feel uncertain, your advisor is there to keep you focused on your long-term plan and to rebalance your portfolio to ensure you are not taking any more risk than you need to reach your objectives.

To use our original analogy, constantly watching the short-term gyrations of the market when your goal may be years away is like reading in a car on a rocky and winding country road. You risk getting car sick.

A better approach is stay focused out the window on that particular point on the horizon that represents your destination. Every now and then, you can pull over to the side and check your roadmap (in this case your financial plan).

Everyone feels the rough ride, it's true. But if you can agree with your advisor that your plan is still the right one for you and that you remain on track to reach your destination, the process of getting there becomes a lot easier.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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