Market**Volatility**

Why It's Increasing. Steps To Take.

By Larry Bakerjian, CFP®

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The danger in today's environment is to be tempted to try to time the stock market. Don't. It's not likely to work, and it doesn't need to. Here's why.

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In late 1998, I enjoyed an article by Walter Russell Mead entitled, "Rule 1: Don't Panic, Rule 2: Panic First" (*Esquire*, October 1998[1]).

It was a catchy headline. The opening artwork showed a man clinging to his bed in a total free-fall. Cash stuffed in the mattress was flying out as bed, mattress and man came crashing down to New York City from somewhere way up in the sky. A second photo showed tombstones lining the street outside the New York Stock Exchange. The article's premise was anything but subtle: Sell stocks now, or you'll get stuck with the tab.

For many, Fall 1998 was a period of great economic uncertainty. Investors were panicky. The *Esquire* article shows the mood at the time:

- "Stock prices could easily fall by two thirds—that's 6,000 points on the Dow[2]—and it could take stocks a decade or more to recover. Many investors could be destroyed."
- "The economic crisis now sweeping the planet may be the most important event—and the most dangerous—since the Second World War."
- "The 500-point Dow crashes of 1987 and 1997 and the 300-point drop of early August show that our stocks, too, have become more volatile with the deregulation of financial markets."

I love the language journalists use—words like “crisis,” “sweeping,” “dangerous,” “crashes” and “destroyed.” Some investors likely read that *Esquire* article (and others like it), panicked and sold some or all of their stock holdings—hoping to “panic first” and sell before others. But *when* should they have “panicked”? It turns out the stock market, as measured by the S&P 500 Index[3], went through two bear markets since 1998,[4] swinging down and then back up significantly two times. If you had hit the panic button after reading the *Esquire* article, would your timing have been good? Would there have been another way to handle the market volatility of the day?

Purpose of This Paper

In this paper, I want you to understand that market volatility is nothing new. While I believe the stock market is *more* volatile today than in times past, there are reasons for this. Even so, today’s “extra” volatility should change nothing *fundamental* about your financial planning process.

Other advisors may tell you differently. They may even urge you to revamp your investment program and do so quickly. While I have suggestions that may play out well in today’s volatile stock market environment, I advocate a long-term view that surpasses making decisions on short-term ups and downs. The key, in my opinion, is to assess your long-term financial needs and goals and to plan adequately for them, whether or not the stock market maintains its volatile character.

Let’s begin with a look at some facts and figures about stock market volatility. Afterwards, I’ll discuss action-steps that may make sense for you.

Stock Market Volatility Today

Despite the feeling of panic characterized by the 1998 *Esquire* article, the 1990s actually represented a relatively calm time for stock trading, according to the *New York Times* article, “The New Normal—Violent Market Swings.”[5] Stock price fluctuations of 1% and more during intraday trading were *more* common in the 1970s and 1980s[6] than in the 1990s.

Today, the pendulum has swung back, so that wide-ranging price swings again feel notable. In fact, “big price moves are more common than they used to be,” reports the *New York Times*.[7]

Here are some statistics:

- Two pieces of data studied from 1962 through the end of August 2011—the closing prices of the S&P 500-stock and the highest and lowest points the index reached during each trading day—rise and fall more often and in greater size today than at other times throughout the study period."[8]

- Since the start of this century, price fluctuations of 4% or more during intraday sessions have occurred "nearly six times more than they did on average in the four decades leading up to 2000."[9]

- More-frequent jumps in closing prices are clear—30% of trading days since the start of 2010 were up or down more than 1% at the time of the closing bell. That's far more than the 20% of such jumps in the 1990s.[10]

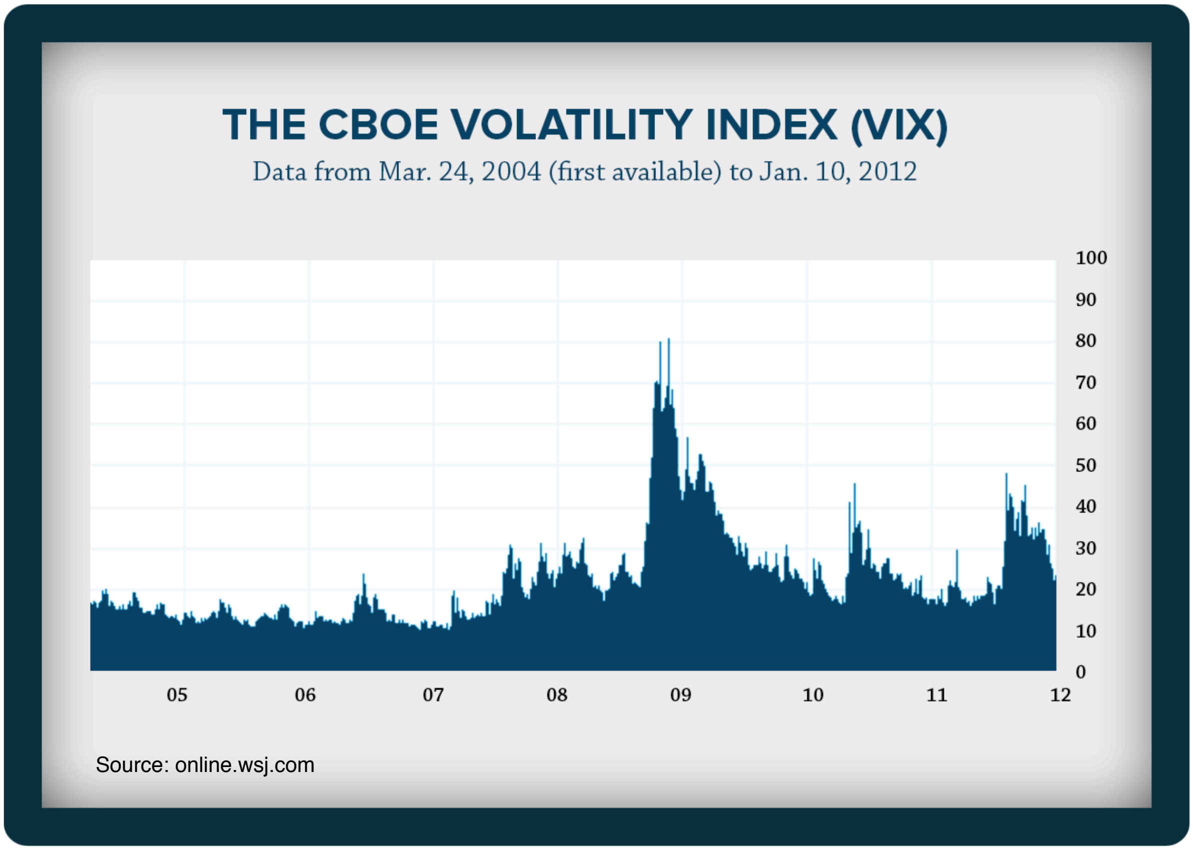
- Since 2000, the Dow has moved an average 0.87% a day, up or down. From August to September 2011, the Dow moved 1.69% a day, almost twice the average for the rest of the 2000s.[11]

Other measures confirm today's greater stock price swings. One is the CBOE Volatility Index, known as VIX.[12] It is seen in the financial press frequently reported as a "fear index." The higher the number, the greater the volatility evidenced in the market.

VIX attempts to measure the likelihood of stock option prices to vary unpredictably. You can see in the nearby chart that late 2008 / early 2009 was an extremely volatile period for stock options and, by deduction, also for stocks. You can also see that volatility is trending higher. Compare the 2009-2011 period to the years prior to 2008.

While critics maintain that VIX's usefulness is overstated, it is considered by many to be a leading indicator of market volatility. In just one day alone, August 8, 2011, the S&P dropped more than 6% and the Dow fell more than 5% on a day of heavy trading. The CBOE Volatility Index jumped 50%.[13]

So, stock market volatility is on the rise. But why? Why are stocks so volatile right now?



Why Volatility Has Increased

There are at least 6 reasons why the markets are so topsy turvy at present:

1. Lack of liquidity.

In stock parlance, liquidity is a term that refers to the ease of getting a trade done at an acceptable price. To facilitate trades, sellers and buyers need to be in good supply. But lately, as investors have gotten nervous, fewer trading partners exist for trades to go through. "That is causing wider-than-normal gaps between prices showing where stocks can be bought and where they can be sold," reports *The Wall Street Journal*.[14]

A lack of liquidity ripples through the markets like waves on a pond. Fearing a lack of selling and buying partners, large investors (typically, hedge-fund traders and mutual-fund managers) tend to step back from the market. They want to avoid the risk of coming up short due to trading difficulties, but this makes the liquidity situation even worse.

"To some degree there's a chicken and egg phenomenon at work," says the *Journal*.[15] "As poor liquidity begets more volatility, big investors and brokerage firms become even more wary of being active in the market. And individual investors, many of whom are out of the market already, are less likely to return."

The result? Fewer investors willing to buy or sell creates a vacuum for stock trading. With fewer players, prices swing with greater fury. Swings in stock prices of even 5% can take place in a matter of minutes during a trading day.[16]

2. Computerized trading.

New computerized trading systems and sophisticated mathematical modeling are amplifying the pricing movements among various stock trades. So pervasive is the use of these systems that regulators at the Securities and Exchange Commission have been "looking at changes in the markets and automated trading strategies in connection with volatility," states the *New York Times*.[17]

"The market is no longer based on one single exchange but is fractured across four big exchanges and several smaller forums," the *Times* adds. "High-frequency traders, using powerful computers to trade at exceptionally high speeds, now account for up to 60% of daily turnover."[18]

3. Legislative brinkmanship.

More and more, investors have to deal with market turmoil that is the direct result of a changing political environment. "I worry that the [U.S. national] debt deal will usher in an era of ever more perilous legislative brinkmanship," says Richard Stengel, Managing Editor, *Time*.[19] Stengel says society was much more divided in the 1960s and 1970s, at a time when Congress was not. Today, he says, culture is less fractious, but not so with the political process.

Others agree. "[We have] difficulties created by a divided government and increasingly polarized political culture," states one article in *Time*.[20] New political tactics focus on “becoming unyielding,” states another, which adds that political parties and their party subsets are becoming “emboldened by the success of their bullying.” [21] This leads to political stalemates in which major economic challenges remain unresolved.

“We couldn't be grappling with [the U.S.’s $14.3 trillion national debt] at a worse time,” says *Time*.[22] “Many economists believe that the economy is fragile.”

Lacking political consensus, the stock market remains fragile, too. Understandably, then, volatility will remain elevated until political parties reach consensus on programs.

4. News spreading more quickly.

The spread of Internet-enabled tablets and phones, along with increased participation on social media messaging sites, such as Twitter and Facebook, have had the effect of propagating financial news more rapidly around the globe. This rapid unfolding of the news—through modern communications—often spurs quick investment trading decisions. These, in turn, can trigger trading frenzies with large price movements.

5. Economic uncertainty.

In many respects, the current period of stock market volatility is a reflection of the extreme uncertainty about the direction of the global economy. The root of the problem is what some call a new economic paradigm. This new paradigm involves low interest rates, slow growth and rising government debt. In a *Time* article entitled, “Deconstructing a Dollar Decline,”[23] Roya Wolverson makes the case that low interest rates work for both the good and bad.

“The downgrade of the U.S.'s AAA credit rating didn't have its expected effect. Instead of fleeing U.S. bonds out of fear of America's doom, nervous investors poured into them as a safe haven. Then the Federal Reserve's promise to keep interest rates cheap until mid-2013—a move meant to coax consumers and businesses to lend and spend—failed to juice the markets.”

The volatile stock market is now "a tug-of-war between those who think global growth will tank and those who see stocks as a bargain."[24] Some investors feel that a falling U.S. dollar, a result of low Fed rates, can boost growth via exports and shave billions off U.S. debt to foreigners. But others worry about a fallout. A weak dollar, in their view, can mean rising inflation in emerging markets, a drop in foreign consumption and pricier imports back in the U.S.

So while lower U.S. interest rates normally help boost U.S. growth, global markets and global problems are "calling that age-old fix into question."[25] And the uncertainty continues. At present, debt woes abound in Greece, Italy, Spain and Portugal. As bad as the European financial crisis is, the U.S. problem is gargantuan. "When measured by total debt, the U.S. has the biggest IOU: $14.3 trillion."[26] How will it get handled? That question makes the markets tremble.

6. Fear feeding on itself.

Finally, market volatility reflects widespread paranoia. "The violent ups and downs," said Robert Shiller, an economics professor at Yale, "may in turn undermine confidence in the economy, and the weakness in the economy can lead to more strident politics—all of which feeds the volatility loop."[27]

Of course, many analysts shrug off the big swings. They say what really matters is where prices close in the longer run, not at the end of each trading day. Still, fear is factor in market dynamics.

For example, on September 21, 2011, CNN reported that the Federal Reserve had pulled the trigger on a widely anticipated stimulus move that involved the sale of $400 billion in short-term Treasuries in exchange for the same amount of longer term bonds. It was hoped that interest rates would drop and create incentives for greater borrowing and spending.[28] But almost immediately after the news was released, U.S. stocks tumbled. Investors questioned the effectiveness of the Federal Reserve's attempt to bolster the faltering U.S. economy. The Dow Jones Industrial Average closed down 2.5%, the S&P 500-stock index shed 3%, and the Nasdaq Composite[29] dropped 2%—all in one day.

The Wall Street Journal reported that the bulk of the declines came late in the trading day —"after the Fed said it would increase its share of longer-term Treasuries by $400 billion by June 2012 in an effort to make credit cheaper and spur spending and investment."[30] Interestingly, the market had largely expected the news. But according to the *Journal,* "the Fed's grim read on the economy was discouraging. Fear prevailed and the markets tanked.

It goes to show you how edgy the markets have become. If a certain news item is "expected" by investors and traders, the ramifications are usually already reflected in stock prices. That the markets sank 2% to 3% in one day shows that the markets are unnerved, somewhat rattled, and largely unprepared to move within a narrow range of price activity.

This has lead some financial historians to declare that the markets are in a "new normal" of permanently heightened volatility. "The last few years have been the most volatile for all of recorded history," said Andrew Lo, professor of finance at the M.I.T. Sloan School of Management.[31] For evidence, Lo says that 10 of the biggest 20 daily upswings and 11 of the largest 20 daily drops, since the beginning of 1980 to the end of [August 2011], have occurred in just the last 3 years.

"The last few years have been the most volatile for all recorded history."

Action Steps

Over the years, I've spent a lot of time looking at investment data. Which allocation strategies work well, which investment managers do a good job, how does monetary and fiscal policy affect investment results, and so on. The goal is to develop overall investment strategies for my clients.

What steps can you take to deal successfully with today's more volatile stock market? The answer is to remain invested in harmony with a plan designed to meet your personal needs and goals.[32] True, it's not always easy to ride through market gyrations, especially when the news media is writing articles that use words, such as, "crisis," "sweeping," "dangerous," "crashes" and "destroyed." But this is why I recommend strategies that can make it easier for you to stick with your investment program.

So, here are some overall strategies for dealing with heightened market volatility:

1. **Allocation:** Match your stock allocation to your situation.

2. **Diversification:** Invest in some assets that do not correlate with the stock market.

3. **Follow your plan:** If it applies to your situation, continue to invest when the markets swoon, since this can lead to significant growth.

While there are no guarantees, some studies show, based on what others have done in the past, that sticking to a disciplined regimen of investing often is the best thing to do in a falling market.

For example, in 2011 Fidelity Investments released the results of a study on how individual investors behaved during the market decline of 2008/2009.[33] Specifically, the study compared the results of 401(k) participants who either (1) sold the stock holdings and never went back during the period, (2) reduced their stock exposure to zero but then reinvested when the market improved, or (3) made no changes to their 401k account balances throughout the course of the market decline and recovery.

While you can read more about the study on my Web site, here's what happened:

- Investors who pulled out of the market in 2008/2009 saw only 2% growth in their 401(k) account balances.
- Those who dropped to 0% equity, but then returned to some level of equity allocation later, saw an average account balance increase of 25%.
- But, those who maintained their investment strategy throughout the period of study experienced *50% growth*.

Clearly, trying to time the market in any meaningful way is difficult. Those investors who panicked lost out when the market rebounded. Those who panicked initially, but later reinvested in stocks did ok. The top group had those participants who remained invested in stocks and continued investing during the volatile period of 2008/2009.

Conclusion

"Panic First"—part of *Esquire's* catchy headline in late 1998—is not good investment advice. While the markets are more volatile these days, trying to time their course is difficult. Generally speaking, short term reactions can cost you in the long run.

Rather than speculate on the market's direction, I encourage you to plan well for the future. What's most effective, in my opinion, is to develop a stock allocation that suits your situation, your objectives and your tolerance for taking risks. Thereafter, work hard to not let short-term bits of market news sway you from following through with your plan.

•Be wary of the mantra to "panic first." Instead, remain invested through the various market cycles. Of course, carefully consider the investment objectives, risks, charges and expenses before making a stock investment decision. Perhaps you can also reexamine your investment strategy annually or whenever your situation changes. ■

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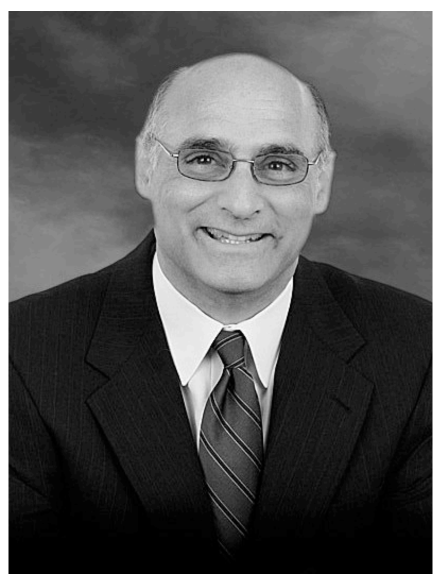

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