Volatility Returns

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Volatility has returned to global financial markets. As seen in figure 1 below, the Volatility Index ("VIX") has spiked to the highest level since 2015. However, looking further back, the VIX is nowhere near the Great Recession of 2008-2009. History proves that volatility in financial markets is nothing new. However, since early 2009, the US markets have enjoyed a low period of volatility.

Coming into 2020, the US Stock market was naturally elevated after a decade long decline in the VIX (figure 2). Price to Earnings (P/E) ratios were also elevated (figure 3). As seen in this chart, in the past high levels of P/E ratios have correlated with weak future stock returns. Finally, heading into the new decade, the percentage change of a recession in the United States was as high (figure 4).

Market volatility is often triggered by a single event but is also multifaceted. The trigger is easy to spot by looking at the headlines: The Coronavirus. While no one knows or can predict the future of the Coronavirus, one thing is certain; markets hate uncertainty. The last two weeks of market action is largely explained by a volatility "trigger" coupled with uncertainty, fear, and elevated financial markets.

Portfolio Considerations

Having a properly diversified portfolio is important at all times, but especially so during market downturns. I've long been a proponent of creating portfolios with the goal of losing less when markets go down. Figure 5 below describes the idea of "downside protection". The idea is a portfolio will perform well in the long run if it loses less (vs. the S&P 500 index in this example) There is never any guarantee that any portfolio will perform well in down markets. However, below are a few strategies that may combat market volatility.

- Allocating to bond and cash markets. Bonds tend to be much less volatile compared with stocks.
- Allocating to gold. Gold can now be bought as a financial instrument through an Exchange-Traded fund as well as through mutual fund managers.
- Using managers that have the freedom to invest in multi-asset portfolios (stocks, bonds, cash, commodities, currencies, etc.)
- Invest with managers that have shown the ability to not be afraid to hold less risky investments during elevated markets.
- Allocating to alternative strategies that may "lose less" or even perform opposite global stock markets.

The Volatility Playbook

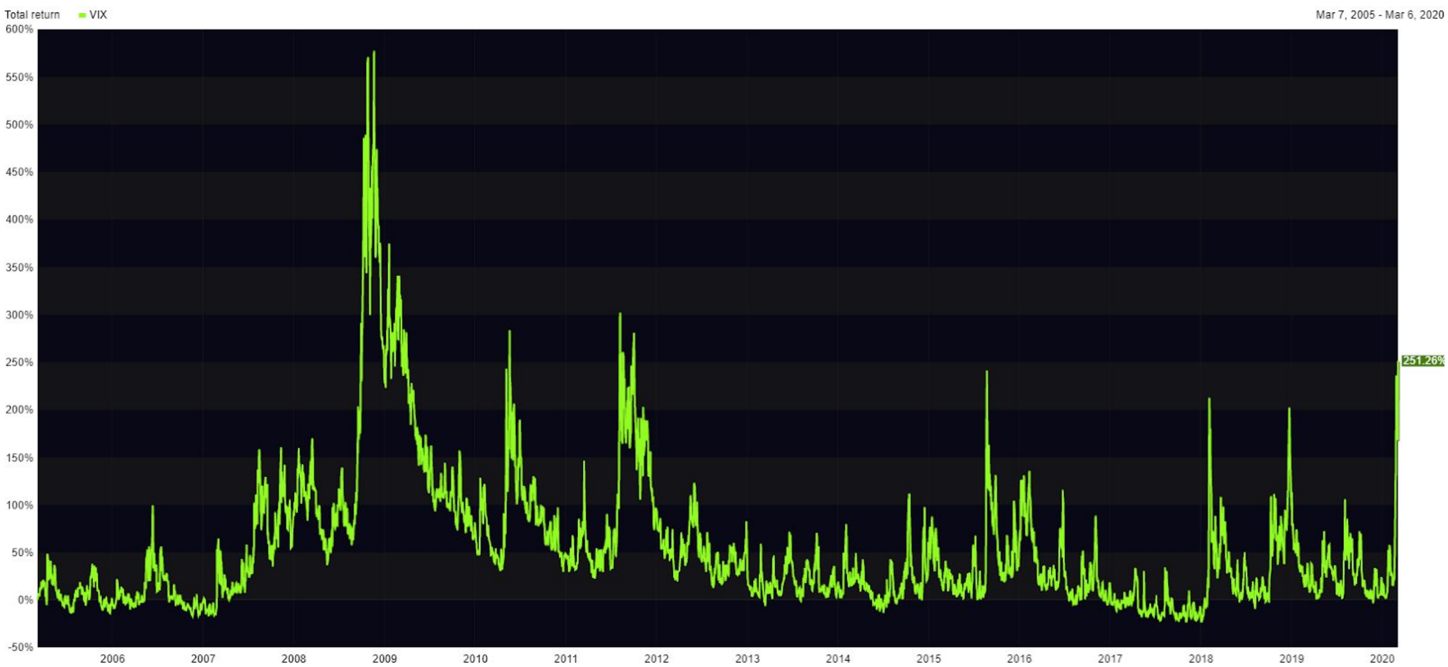
So what's the playbook when fear enters the markets? Remembering key messages about markets and portfolio construction can be helpful during these times:

- Market volatility is normal.
- History shows us that stock markets go up and down.
- Do not panic.
- Investing is a long-term venture.
- Stocks are upward trending over time.
- Bonds always play a role in portfolios.
- Do not be quick to sell stocks during down markets.
- Be patient with managers that are underperforming the market as long as the strategy has not changed.
- Set and review "percentage bands" in terms of asset allocation and individual managers.
- Take advantage of depressed stock markets and buy when stocks are cheap.
- Trust in the portfolio as constructed and be patient.

Conclusion

Volatility is normal. As I stated before, the last two weeks of market action is largely explained by a volatility "trigger" coupled with uncertainty, fear, and elevated financial markets. It's important now more than ever to be patient in managing portfolios in the wake of recent market events.

Figure 1: VIX (15-Years)

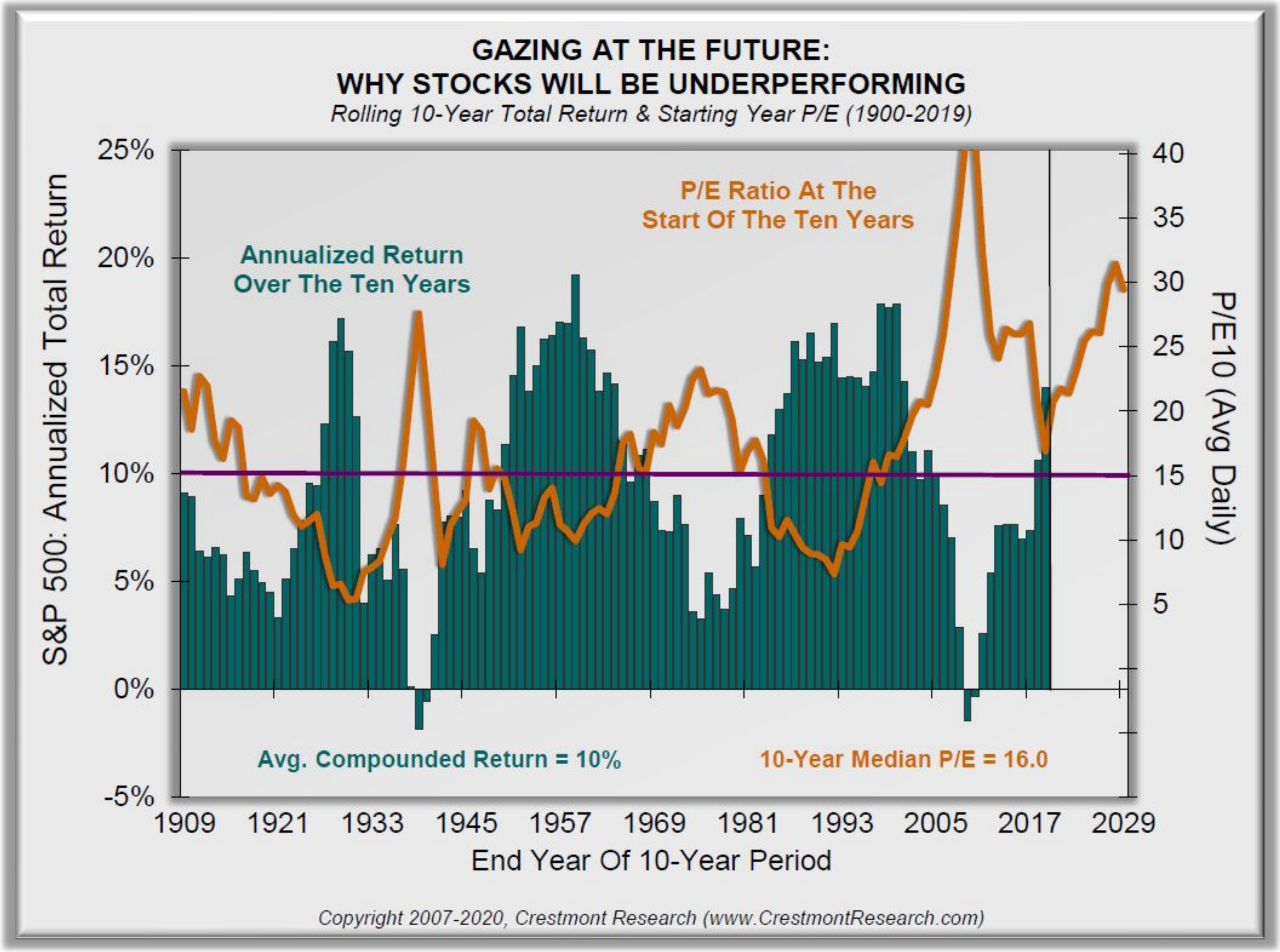


Source: Kwanti

Figure 2: Bull Market in Equities

Source: David Rosenberg

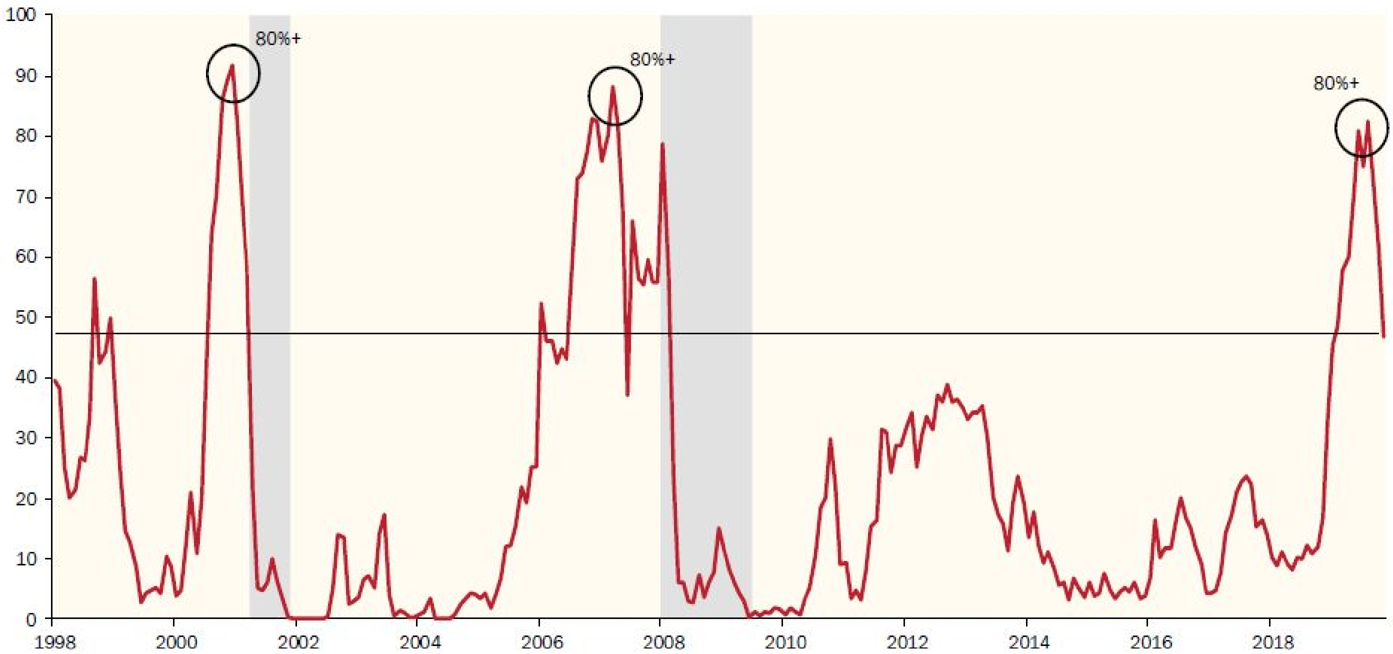
Figure 3: P/E Ratios & Stock Performance



Source: Crestmont Research

Figure 4: Probability of a Recession 12 Months Ahead

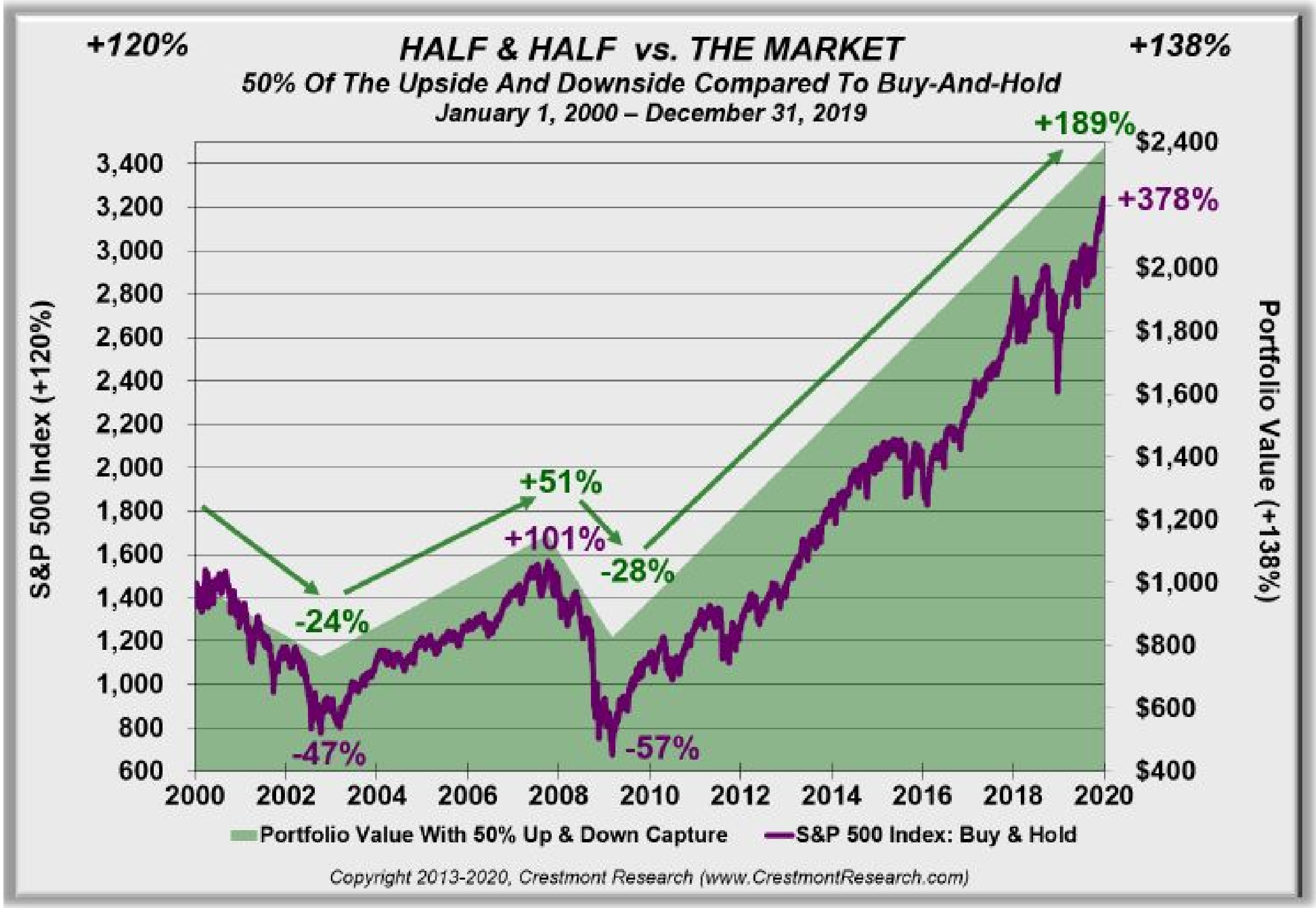
United States
(percent)



As predicted by the near-term treasury spread
Shaded regions represent periods of U.S. recession

Source: David Rosenberg

Figure 5: Half & Half



Source: Crestmont Research

References

- Rosenberg Research - Economic Commentary "The Year Ahead 2020"
- Crestmont Research - Quarterly Charts Q1 2020

DISCLOSURES & INDEX DESCRIPTIONS

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not reflect fees or expenses.

The MSCI ACWI (All Country World Index) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of June 2009 the MSCI ACWI consisted of 45 country indices comprising 23 developed and 22 emerging market country indices.

The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index.

The Russell 3000 Index® measures the performance of the 3,000 largest U.S. companies based on total market capitalization.

The Russell Midcap Index ® measures the performance of the 800 smallest companies in the Russell 1000 Index.

The Russell 2000 Index ® measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

The MSCI® EAFE (Europe, Australia, Far East) Net Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises 21 MSCI country indexes, representing the developed markets outside of North America.

The MSCI Emerging Markets Index SM is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2007, the MSCI Emerging Markets Index consisted of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The MSCI Europe Index is part of the Modern Index Strategy and represents the performance of large and mid-cap equities across 15 developed countries in Europe. The Index has a number of sub-Indexes which cover various sub-regions market segments/sizes, sectors and covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 322 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

The Dow Jones Composite REIT Index measures the performance of Real Estate Investment Trusts (REIT) and other companies that invest directly or indirectly through development, management or ownership, including properties.

The Alerian MLP Index is the leading gauge of energy infrastructure Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

The HFRX Global Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry. Hedge Fund Research, Inc. (HFR) utilizes a UCITSIII compliant methodology to construct the HFRX Hedge Fund Indices. The methodology is based on defined and predetermined rules and objective criteria to select and rebalance components to maximize representation of the Hedge Fund Universe. HFRX Indices utilize state-of-the-art quantitative techniques and analysis; multi-level screening, cluster analysis, Monte-Carlo simulations and optimization techniques ensure that each Index is a pure representation of its corresponding investment focus.

The Barclays Commodity Index is composed of futures contracts on physical commodities and represents twenty two separate commodities traded on U.S. exchanges, with the exception of aluminum, nickel, and zinc.

The U.S. dollar index (USDX) is a measure of the value of the U.S. dollar relative to the value of a basket of currencies of the majority of the U.S.'s most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.

The US Dollar Index is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies.

The Cboe Volatility Index® (VIX® Index) is considered by many to be the world's premier barometer of equity market volatility. The VIX Index is based on real-time prices of options on the S&P 500® Index (SPX) and is designed to reflect investors' consensus view of future (30-day) expected stock market volatility. The VIX Index is often referred to as the market's "fear gauge".

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

The S&P CoreLogic Case-Shiller Home Price Indices are the leading measures of U.S. residential real estate prices, tracking changes in the value of residential real estate both nationally as well as in 20 metropolitan regions

The Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

The Barclays U.S. Treasury Index is U.S. Treasury component of the U.S. Government index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Treasury bills are excluded (because of the maturity constraint). Certain special issues, such as flower bonds, targeted investor notes (TINs), and state and local government series (SLGs) bonds are excluded. Coupon issues that have been stripped are reflected in the index based on the underlying coupon issue rather than in stripped form. Thus STRIPS are excluded from the index because their inclusion would result in double counting. However, for investors with significant holdings of STRIPS, customized benchmarks are available that include STRIPS and a corresponding decreased weighting of coupon issues. Treasuries not included in the Aggregate Index, such as bills, coupons, and bellwethers, can be found in the index group Other Government on the Index Map. As of December 31, 1997, Treasury Inflation-Protected Securities (Tips) have been removed from the Aggregate Index. The Tips index is now a component of the Global Real index group.

The Barclays U.S. Treasury: 1-3 Year includes securities in the Treasury Index (i.e., public obligations of the U.S. Treasury) with a maturity from 1 up to (but not including) 3 years.

U.S. Treasury Bill 90 Days Rate is an index comprised of short-term obligations issued by the United States government.

The Barclays Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.

The Barclays U.S. Corporate Investment Grade Index is the Corporate component of the U.S. Credit index. Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

The Barclays U.S. Corporate High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody’s, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

The Barclays Global Aggregate Bond Index provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities.

The Barclays Emerging Markets USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set. Country eligibility and classification as an Emerging Market is rules-based and reviewed on an annual basis using World Bank income group and International Monetary Fund (IMF) country classifications. This index was previously called the Barclays US EM Index and history is available back to 1993.

Index Date Sources: MSCI, Russell, Standard & Poors, Morningstar, Kwanti, Barclays, Hatteras, HFRX

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International investing involves additional risks, including currency fluctuations, political or economic conditions affecting the foreign country, and differences in accounting standards and foreign regulations. These risks are magnified in emerging markets. Small and mid-cap stocks carry greater risks than investments in larger, more established companies. Fixed-income securities are subject to interest-rate risk. Investing in high-income securities may carry a greater risk of nonpayment of interest or principal than higher-rated bonds. Investing in commodities is generally considered speculative because of the significant potential for investment loss due to cyclical economic conditions, sudden political events, and adverse international monetary policies. There are several risks associated with alternative or non-traditional investments above and beyond the typical risks associated with traditional investments including higher fees, more complex/less transparent investment strategies, less liquid investments and potentially less tax-friendly. Some strategies may disappoint in strong up markets and may not diversify risk in extreme down markets.

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