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Volatility Picks Up in 2018

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By now, you are certainly aware of the recent market sell-off. In addition to our monthly commentary, I thought it helpful to provide some additional comments. I can appreciate the stress that comes with increased volatility, but it is also important to put things in perspective. While we haven't seen such a big drop in recent years, it does happen more often that people think. For the average investor, the way the media describes these events can be very scary. They use words like devastating, crash, collapse, blood, etc. If that doesn't grab your attention, I don't know what will. As a professional investor, it is my job to look through the noise and determine what is really happening. That is why people hire me to manage their money. Knee-jerk reactions often cause investors to make big mistakes that can take a long time to fix.

So, why the drop? There is no single answer, but there are a few things that I think have sparked this sell-off. First, we just came out of a terrific 2017, as well as a great January, and many large investors had to sell some of their equity exposure to get back in line with their targeted allocations. Second, economic data has been strong, and the market feared the Fed will be more aggressive in raising rates. Third, the 10-year U.S. Treasury yield spiked to over 2.8%, forcing stock valuations to adjust. And finally, large positions in certain leveraged derivatives products that bet on low volatility reversed and led to a bigger sell-off in the market.

Now, many of you may think that these corrections are rare, but they aren't. Normal market conditions often have 10% corrections within a bull market. I took a look at SPY (an ETF that tracks the S&P 500 Index) over the past 8 years to see what kind of drawdowns we experienced and what happened a year later (see table below).

Start Date	End Date	Approximate Change
7/6/2011	8/8/2011	**-16.10%**
8/9/2011	8/9/2012	**+27.91%**
10/28/2011	11/25/2011	**-9.48%**
11/28/2011	11/28/2012	**+24.20%**
4/30/2012	6/1/2012	**-8.71%**
6/2/2012	6/2/2013	**+30.37%**
7/17/2015	8/25/2015	**-11.79%**
8/26/2015	8/26/2016	**+18.55%**
12/31/2015	2/11/2016	**-11.20%**
2/12/2016	2/12/2017	**+29.32%**

As the table above shows, we have had a number of big drawdowns. However, each of these pullbacks resulted in very nice returns a year later. There is always something to worry about when it comes to the stock market. In 2011, we had the Eurozone crisis, and after 2 big drawdowns, we had strong returns a year later. In 2012, we had a presidential election with a fiscal cliff looming, and after the drawdown in May, we again saw strong performance. In 2015, everyone was concerned about China's economy and falling oil prices, causing 2 big drawdowns within 6 months of each other. And yes, these drawdowns were also followed by a significant runup in stock market prices.

I'm not trying to say that you should never worry about anything. But as Mark Twain said, "History doesn't repeat itself but if often rhymes." If we continue to see corporate earnings growth, strong employment, economic expansion, low inflation, and reasonable interest rates, there is no need to panic. For a market correction to become a serious bear market, we need a catalyst. A catalyst will develop at some point, and we will watch for it. For now, that catalyst doesn't exist.

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I will leave you with one final thought. If I told you at the end of 2017 that the market would be flat for the first 2 months of 2018, would you panic or be worried? Well, as of the close on 2/6/2018, the S&P 500 Index is +0.81% for the year. It is nearly impossible to time the market even for the most experienced traders. Investing is a process of balancing risk to achieve a certain outcome. We can control risk, but from day to day, the market's behavior is nearly impossible to predict. Stay focused on what you're trying to accomplish and why you are investing. Most of my clients have a longer time horizon and shouldn't be distracted by short-term fluctuations in the market, no matter how large the swings. When real fundamental macroeconomic problems develop, we will make the necessary adjustments. For now, we will stay focused and pay attention.

As always, if you have any questions or concerns, please feel free to call.

Best Regards,

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