Guess Who’s Coming To Dinner?

*How To Prepare Your Association’s Investments For The Threat Of Market Volatility*

We all have THAT relative. The one you hope to see only once every few years. The one that leaves the house a mess, believes his personal political beliefs should be government policy, and always finds a way to have one too many glasses of wine with dinner. He’s not always there, but when he is, he generally makes life miserable for everyone around him.

For investors, THAT relative is market volatility. Uncle Volatility hasn’t been around much for the past five years. And, not surprisingly, no one’s complained. After all, the global equity markets have produced double digit annualized returns over that time. And in a low interest rate environment, bond returns haven’t been too shabby either. But many are of the opinion that Uncle Volatility is coming back, and he may be packing a large suitcase. Here’s why he’s coming and what your association can do to prepare.

The Threat

A popular measure of equity market volatility is the CBOE Volatility Index (“VIX”). VIX measures market expectations of near-term volatility conveyed by S&P 500 Index (SPX) option prices. Simply viewed, the higher the value of the index, the higher the degree of equity market volatility. Historically, the VIX has averaged about 20. However, over the past five years, the VIX has spent a good portion of its time below this average. But a number of factors could reverse this trend going forward. First is the possibility of rising interest rates domestically. The Federal Reserve’s ZIRP (Zero Interest Rate Policy) has kept interest rates low and helped to push capital into riskier assets (such as stocks). The Fed may begin raising rates soon (many predict sometime this year), beginning the process of removing a key market tailwind over the past five years. Second is equity market valuations. Stocks (domestically at least) are no longer “cheap” (when considering price/earnings ratios) and, by some measures, maybe even a little expensive. Third is slowing global growth. The IMF (International Monetary Fund) has reduced global growth expectations for 2015, in large part due to a slowdown in emerging markets and continued anemic growth in Europe. The U.S. is being counted on to help lead the way, but an ever strengthening dollar may cut into the ability of globally diversified companies to sell overseas. Fourth is geopolitical uncertainty. Conflicts—both hot and cold—in areas like Iran, Syria and Russia are unpredictable and have the ability to inject volatility into the markets. Oh, and let’s not forget that we’re about to enter a presidential election cycle!

What To Do

You can’t control if he visits or how long he stays, but you can control how you deal with Uncle Volatility’s visit.

First, revisit your investment policy. Your policy should outline the acceptable level of risk tolerance. This should be something as simple as “conservative” or “moderately aggressive”. It should clearly spell out the level of acceptable returns and the probability of those occurring.

Second, stay diversified. Diversification hasn’t really been an investor’s best friend over the past five years. Common diversifiers like REITs, foreign stocks, and hedge funds have frequently found themselves gasping for air as blue chip U.S. stocks have sprinted ahead. But in a volatile market, its these diversifiers that can help to spread out your exposure.

Third, shore up your “safety” net. In the past, bonds have acted as a “safety net”, helping to cushion the volatility of risk assets in your portfolio. However, as mentioned earlier, rising interest rates are viewed as a potential catalyst for market volatility. And bonds tend to not fare well as interest rates rise, particularly those bonds with longer maturities. So, what do you do when your safety net is under attack? Prepare for the potential for rising rates through duration management, opportunistic manager selection and sector management.

Finally, consider non-correlated investment strategies to further increase diversification as well as your opportunity set. A good example of this is alternative investments. Long a favorite of public funds and university endowments, associations have largely been reluctant to embrace this asset class. There are many reasons to be wary; illiquidity, high expenses, questions from auditors. But we suspect that the main reason is a common perception that “hedge funds” (and similar vehicles) are high risk, high return strategies where you can potentially lose your entire investment. While this can be true, many alternative investments are designed to be low volatility with predictable returns. They are designed to have low correlation to more “traditional’ investments. But the landscape is changing. Liquid alternatives (i.e., “hedge fund like” mutual funds that trade daily and have daily valuation) are an ever-growing element of the alternatives space, and many of the larger names in the alternatives industry have either established or intend to establish mutual fund offerings. But these are new and unproven, and like any flavor of the month, some are not going to taste so good. Give them careful consideration, but weigh all the potential risks and benefits that alternative investments have to offer, in all their forms.

Now, get your guest room ready. I think I hear a knock at the door…

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