Why Didn't We See It Coming?

SYNOPSIS

- The DIAS portfolios utilize tactical strategies to shield investors against volatility in order to preserve capital and smooth out returns over time.
- The recent equity market decline took stocks down over 10% in a matter of days, and some investors want to know why we didn't see the "correction" coming.
- Volatility that strikes in this manner is usually unpredictable, but it also rarely stays around long enough to warrant any real concern or action.

ARE WE BLIND?

Back in August, China shocked the world by devaluing their currency, which wreaked havoc across global financial markets. Trillions of dollars of value were wiped out in days over fears that the second largest economy in the world was slowing.

Those country's economies who are dependent upon China for supplying raw materials were hit the hardest. Developed markets also saw equity prices fall, as market pundits raised alarms that a slowdown in China could eventually impact Japan, Europe, and even the U.S. economy.

The panic was so intense that the S&P 500 experienced its first "correction" in over four years. A correction is a term used on Wall Street when an asset has fallen over 10% from a previous high, and traders had been fixated on the timing of this most recent correction for years now.

Given that one of the mandates for the DIAS portfolios is capital preservation, some investors have asked (1) why we did not see the correction coming, and (2) why we didn't go to cash to preserve capital through the spike in volatility.

Before we discuss why we did not see this correction coming, let's first explain our strategy for managing volatility and risk in order to preserve capital over the long run.

Those who remained focused and disciplined came out just fine because they realized that not even 9/11 could derail the world's largest and most robust economy.

REAL RISK DEVELOPS OVER TIME

Risks to the fundamentals take time to materialize, and leading indicators alert astute investors to prepare for economic weakness. When we see the potential for volatility and/or risk, we will take the necessary steps in order to prevent paper losses as best as possible.

For example, back in 2008, we carried very large cash balances because we strongly believed that a recession was looming. We did not come to that conclusion in a single week/day/hour, but rather, over time as we watched trends develop.

***NOTE**: This year, we have made major shifts in our allocation to prepare portfolios for an extended period of slowly rising interest rates. There's no way to know when rates will begin to move up, but we would rather be safe than sorry, so we made our move early and gradually implemented throughout the year.*

Recessions can dramatically alter the financial future of those investors who do not have a multi-decade investment horizon, and our goal is to avoid these instances where markets drop for an extended period of time.

However, shorter periods of volatility, whether it be quarterly, monthly, or even weekly, cannot possibly be managed because the short-term movements in markets are nothing more than emotional responses and bear no semblance to the underlying fundamentals of an economy.

Hence, there are four main reasons why we made no attempt to go to cash prior to and during this most recent equity market correction:

1. **No Crystal Ball:** There are some forms of volatility that are simply unpredictable. No investor alive could have guessed that the Chinese government would devalue at that moment, and then subsequently assume that the world would go into hyper-panic mode.
2. **Nature of These Spikes:** This type of volatility that catches investors off guard is almost always short-lived because it's nothing more than an emotional reaction to the uncertainty surrounding the catalyst. Once it stops making page one headlines, it often goes away (just as the turmoil in Greece from June seems to no longer matter).
3. **Taxes:** Even if we could somehow predict short-term corrections, selling only to buy a few days/weeks later can often incur tax issues that can quickly wipe out any benefit to a long-term investor.
4. **Fundamentals Haven't Changed:** Our investment style is predicated upon analyzing key fundamental trends in economies and companies alike. The emotional responses that cause volatility spikes almost never alter the longer term story, and this time is no different. As in, the risk of a recession remains very low in the U.S.

Let's take a look at another example of a volatility spike that caught the world off guard.

Source: Bloomberg

The left-side of the chart shows just how fast the S&P 500 sold off, once markets were reopened after the terrorist attacks on September 11, 2001. Within a very short time period, our equity markets lost over 8% in total value. However, days later, the index recovered and then continued its way up over the coming years.

Nobody saw the attacks coming, and a lot of investors who sold into the panic lost a lot of money. Those who remained focused and disciplined, came out just fine because they realized that not even 9/11 could derail the world's largest and most robust economy.

Simply put, if the worst terrorist attack on U.S. soil since Pearl Harbor was not enough to drive us into a recession, China's economy will not either (especially since we have next to no reliance on them).

IMPLICATIONS FOR INVESTORS

An unfortunate reality of investing in equities is that they often sell off hard with little to no warning. Since the short-term movements in markets are driven by sentiment, gauging the emotional stability of financial markets consistently is impossible.

The good news is that long-term investors don't have to even try, because these periods of panic never change the fundamentals. There have been 29 corrections since 1950, including this most recent one. In each of the first 28 instances, the market has (1) recovered, and (2) eventually risen to a new high over time. I'm confident that this streak will remain alive.

The bottom line is that nobody can accurately time corrections consistently, but since they tend to be short-lived and rarely indicative of the long-term fundamentals, doing so will not provide much value. In fact, any attempt to do so will likely cause more harm than good to a portfolio.

Sincerely,

Mike Sorrentino, CFA
Chief Strategist,
Aviance Capital Management
mikeonmarkets.com