QMα Insights

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Fight or flight: thoughts on recent market volatility

In October of 2014, investors were tested as fears of the Ebola virus, weak global economic growth and heightened geopolitical tensions sent stocks sharply lower.

The challenge: Investors had to ask themselves, is this decline the beginning of something worse? Should we all sell and seek safety, stay the course or buy the dip?

RSVP

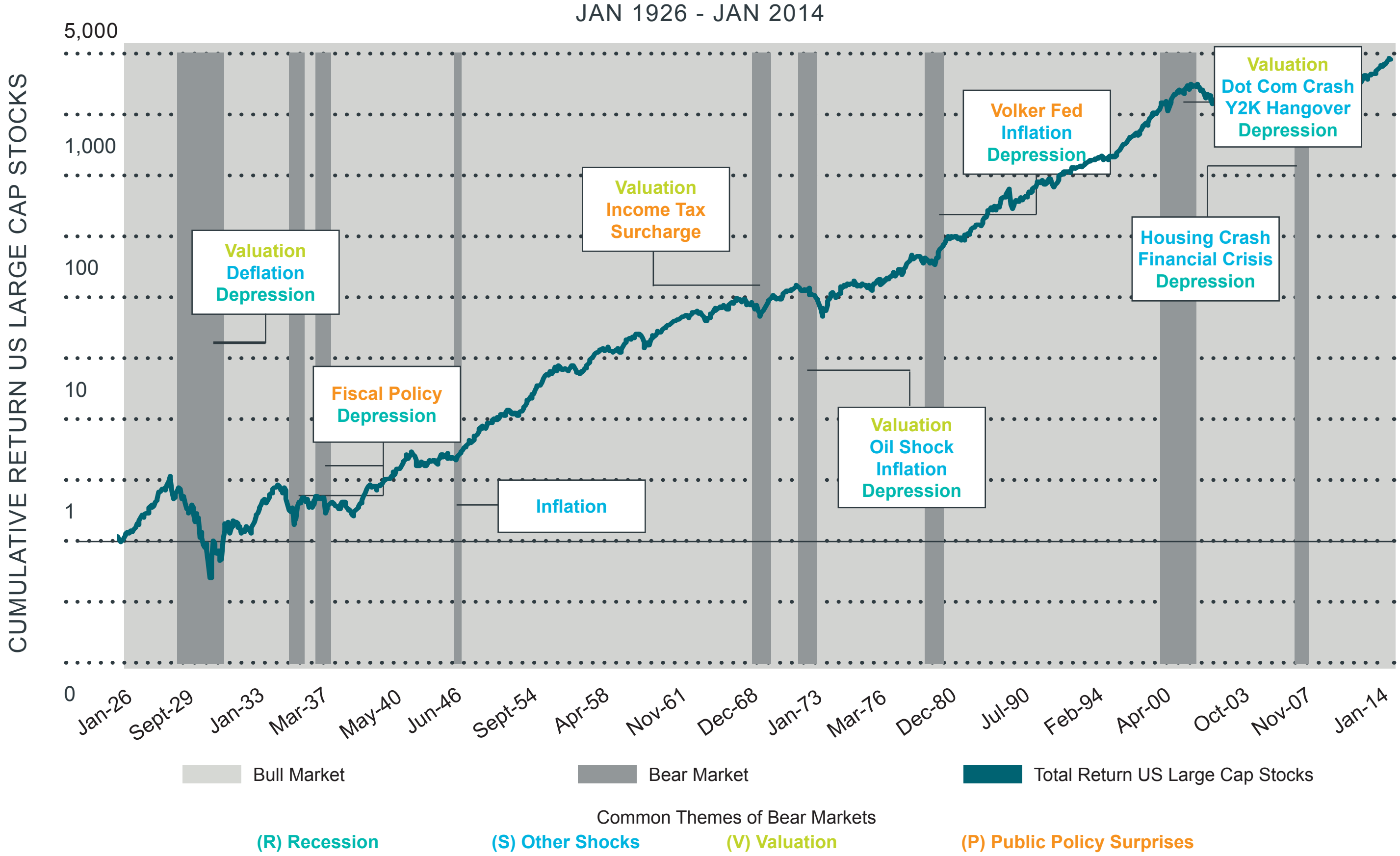
Recession, shocks, valuation, public policy surprises

At QMA, we've developed a framework to help address these questions that we call RSVP.

Most of the time stocks tend to rise as the economy grows; the historical average total return for US stocks has been 10%. A basic optimism has generally served equity investors well. The trouble is that the little down wiggles on the log of equity return in Figure 1 might not look like much, but they can represent a drop of 50%. Investors tend to be quite annoyed when they lose half their money. Is it possible for investment managers to deliver most of that 10% upside while avoiding some of those nasty drops? None of us has a crystal ball, and investment returns are mostly earned as a reward for bearing risk.

FIGURE 1: WHAT ANGERED THE BIG BEARS?

JAN 1926 - JAN 2014



Source: QMA, Ibbotson Associates.

What might cause the next bear market?

We looked at what we believe to have been the proximate causes of the prolonged bear markets since 1926, and we have categorized them as either: Recession, Shocks, Valuation and Public Policy Surprises—or RSVP.

Recession – Recessions are often associated with bear markets, most dramatically during the Great Depression. Most recently, the Great Recession of 2008-2009 certainly contributed to the bear market.

Shocks – Shocks of various types (including the housing crash and financial panic) have often contributed to bear markets, for example the OPEC embargo and huge oil price increases of 1973-1974 and 1979. By definition, however, shocks are tough to predict. War, terrorist attacks, a natural disaster, or some other event might turn out to be the driver of the next bear market, and investors need to be alert to every possibility.

Valuation – When valuations are higher than normal, the market becomes quite vulnerable to bad news or shocks. Alan Greenspan warned of possible "irrational exuberance" in 1996, but the market would move much higher for nearly four more years before it crashed. Valuation is not a precise market timing tool, but it is a useful investment tool. Very high valuations have often preceded bear markets.

Public Policy Surprises – Sudden changes in fiscal or monetary policy can have a profound impact on the markets. Perhaps the most dramatic such change in the past few decades was the decision by the Volker Fed to raise rates to record levels in the early 1980s as a way to crush inflation. The policy eventually worked, and many believe that it helped set the stage for the multi-decade bull markets in stocks and bonds that followed—but not before precipitating a nasty bear market in the short term.

Applying RSVP in real time

So how did we apply this framework in October of 2014? By October 15, the stock market had fallen over 7% from its peak. Some thought that the long-awaited and oft-predicted correction was underway; or perhaps the correction would spiral down to a full-fledged bear market (e.g. a potential 20% or greater decline from the peak and negative returns over a 12-month period). At QMA, we asked ourselves whether the success of our bullish stance of recent years had made us complacent, whether it was time to pull back and take some risk off the table. To address this, we applied the RSVP framework we had developed at the beginning of the year:

Recession – We thought it quite unlikely that the U.S. would enter a recession in 2014 or 2015. All the data we considered indicated that growth in the 3% range was likely to continue for several more quarters. True, Europe was probably close to recession, but U.S. exports to Europe represent only about 1% of U.S. GDP. Global growth has slowed, but still seemed to be running about 3% or better. So our opinion was no, we are not on the verge of recession.

Shocks – In mid-October, fear of the Ebola virus had reached a high level. Global hot spots in the Middle East, Eastern Europe, Asia and elsewhere seemed to feed investor anxiety. Would these events drive a bear market? By definition, shocks are tough to predict. We are not infectious disease experts, but after studying the work of those who are, we thought a widespread Ebola outbreak outside of the tragically effected countries in Africa was unlikely. So though we can never be sure when a shock might surprise us, we did not think the possible shocks on the horizon would be powerful enough to cause a bear market.

Valuation – The trailing and forward P/E ratios of the S&P 500 were roughly equal to their historical averages. The dividend yield of the S&P 500 rose meaningfully above the 10-year Treasury bond yield in mid-October. The dividend yield on the German DAX index was about 3%, more than triple the yield on the German Bund. As recently as 2005, the dividend yield on the DAX was half the bund yield. Low interest rates might signal a relatively low return environment over the next several years, but the risk premium imbedded in stock prices was high enough, we thought, to drive significant outperformance of stocks versus bonds in the years ahead. So no, we did not think that valuations were high enough to cause a bear market.

Public Policy Surprises – Fiscal policy in the U.S. is basically frozen as a result of differences between the two major parties. We did not think that would change soon, regardless of the outcome of the mid-term elections. Might monetary policy suddenly tighten, and cause a bear market? We thought that unlikely. Chair Yellen has made it clear that she wants to see significant progress on a stronger labor market and evidence that inflation was moving up to or over the Fed's 2% target before monetary policy would be meaningfully tightened. With wage growth still modest and inflation measures more likely to fall than rise due to the sharp drop in oil prices, we thought that Fed tightening would be unlikely to occur until mid-2015 or later. We thought an imminent policy shift was unlikely to cause a bear market.

Having applied our framework, we stuck with our portfolio tilt towards stocks and other risky assets. We were net buyers of stocks in mid October, and our clients benefitted from the mid-month rebound.

Of course, no framework is perfect, and we employ more complex models as well as part of our investment decision-making at QMA. But in its first real test, we think our simple RSVP framework served us well.

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For more information

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About QMA

Since 1975, QMA has served investors by combining experienced judgment with detailed investment research in an attempt to capture repeatable long-term outperformance. Today, we manage approximately $112 billion in assets globally for institutions, sub-advisory clients and individual investors through a broad mix of asset allocation, core equity, value equity and indexing solutions.

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