Returning with a Vengeance

In this case, Volatility. Tuesday's WSJ headline: **Stock Plunge Erases Year's Gains,** followed by Dow industrials tumble over 1,100 in biggest point drop ever; 'panic-type selling'

By *Akane Otani*
February 5, 2018

The long-running global stock rally turned into a rout Monday as the Dow Jones Industrial Average posted its largest-ever, single-day point decline and major indexes in the U.S., Europe and Asia gave up their gains for the year.

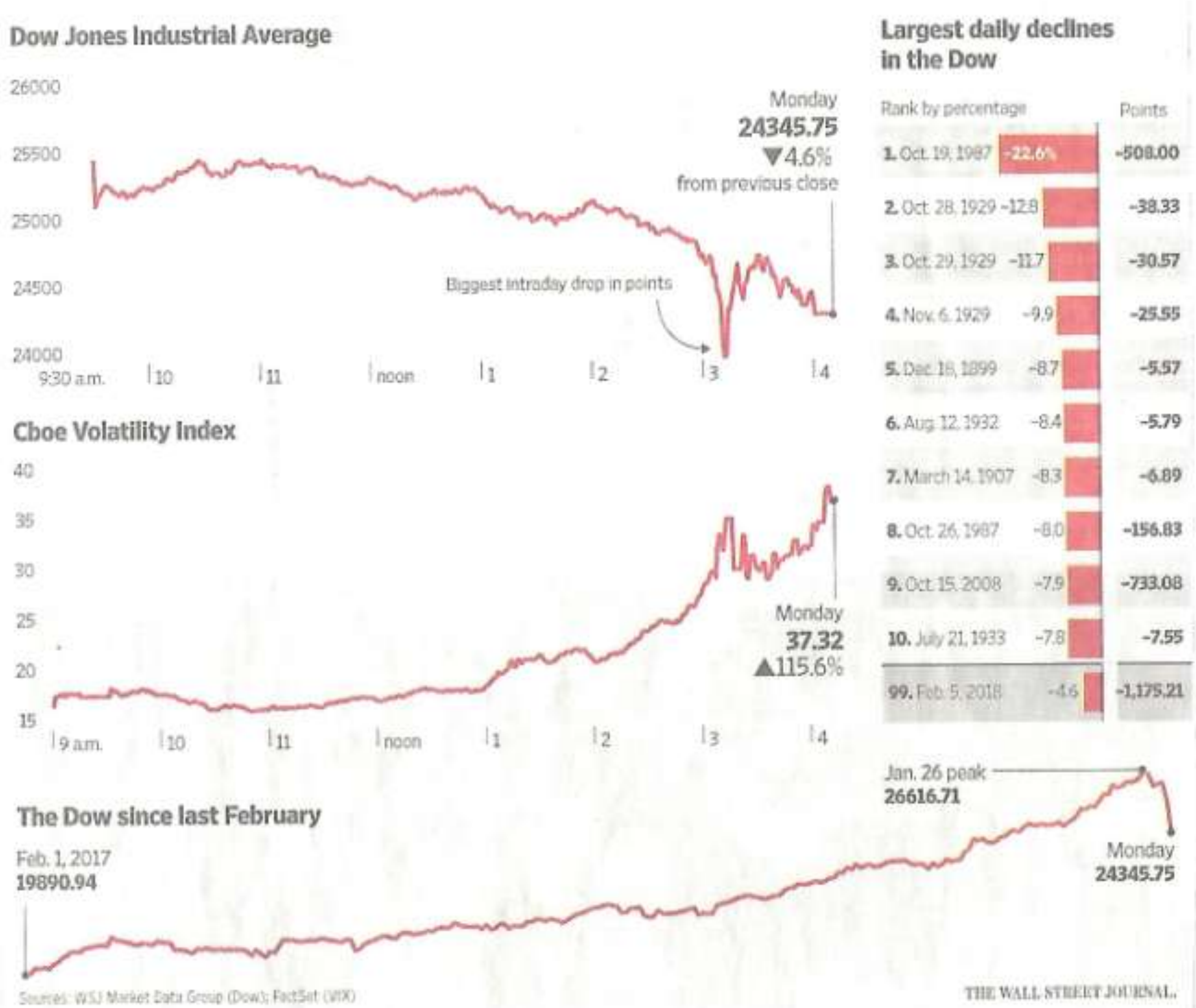
Traders described a growing sense of anxiety throughout the day and the Dow briefly dropped nearly 1,600 points. ... the blue-chip index closed down 1,175.21 points, or 4.6%, to 24345.75, its largest one-day percentage decline since August 2011. ...

Combined with steep falls Friday, the index has lost 7% in just two days, marking a break in the tranquility that has characterized financial markets for much of the past two years. ...

The Dow is now down 1.5% for the year and off 8.5% from its Jan. 26 high, approaching the 10% fall that would mark a correction.

The sharp drop, coming just six trading days after the S&P 500 and Nasdaq Composite also surged to all-time highs, marked a stunning turnaround. Global stocks in January posted one of their best-ever starts to a year, buoyed by hopes for faster economic growth around the world and the just-enacted U.S. tax-code overhaul.

Enthusiasm for stocks led investors to pour a record $102 billion in January into mutual funds and exchange-traded funds that invest in equities globally.



But cracks emerged last week when government bond yields jumped to four-year highs, raising fears among some investors of a faster-than-expected pickup in inflation. ...

The S&P 500 fell 4.1% Monday and the Nasdaq Composite dropped 3.8%. The Dow and S&P 500 are at their lowest levels since early December.

Meanwhile, the yield on the 10-year U.S. Treasury fell to 2.794%, down from a four-year high of 2.852% Friday. The fall marked the steepest one-day yield decline in five months.

As investors grasped for reasons behind the moves, some traders said they appeared to be caused in part by algorithmic trading. As evidence, they noted how quickly the selling accelerated, only to abate a bit in the last half-hour of the session. ...

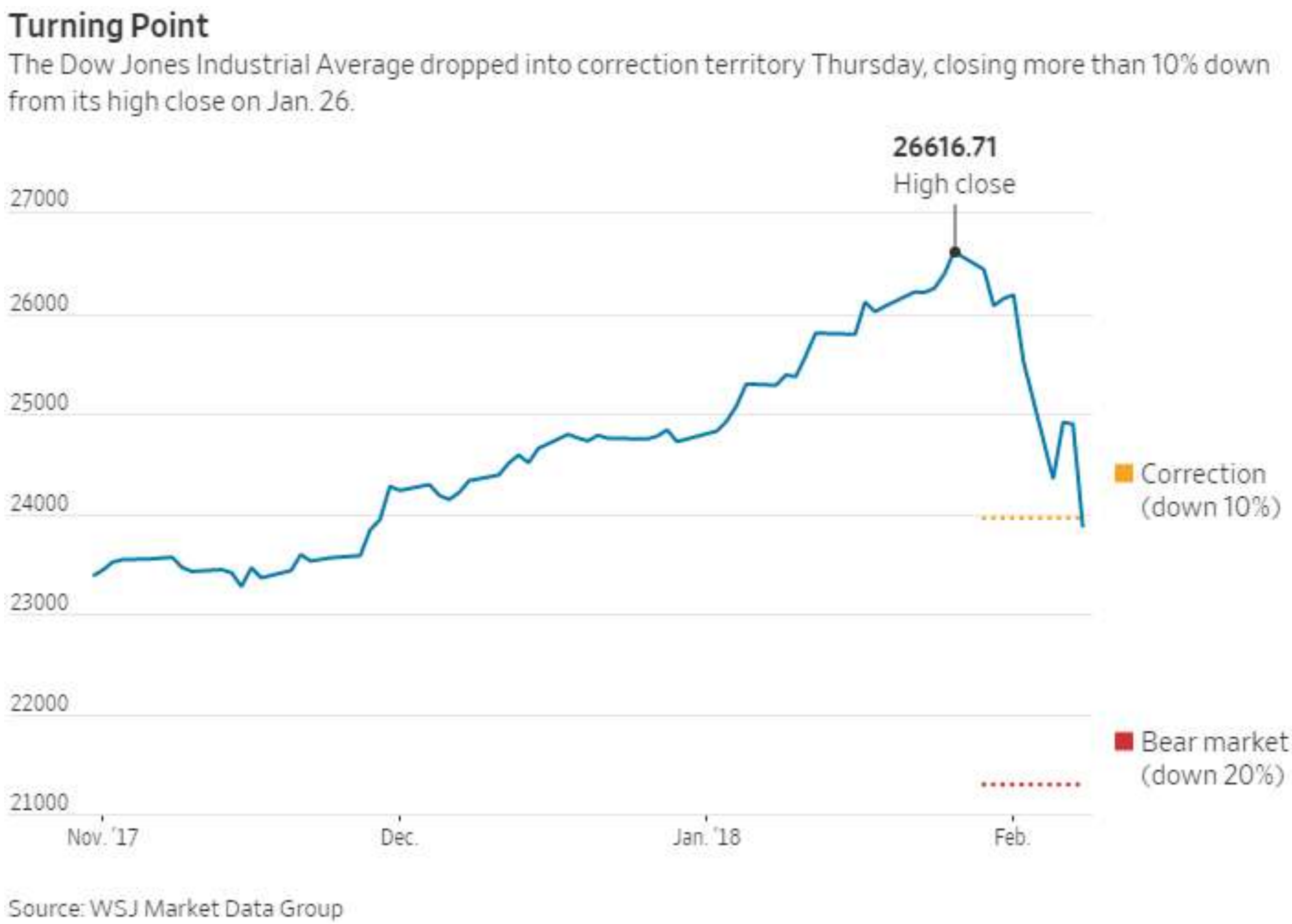
Monday's selling was broad-based, with all 11 sectors in the S&P 500 posting declines. ...

Meanwhile, a measure of expected swings in the S&P 500, the Cboe Volatility Index, shot higher, jumping 117%—its largest one-day percentage gain ever. ...

On Thursday stocks retested Tuesday's panic low, with both the S&P 500 and Dow now officially in a correction. Friday's WSJ headline: **Jitters Deepen Market Slide**, followed by Rising interest rates and volatility rattle investors, sending stocks into correction

By *Akane Otani* and *Jon Sindreu*
Feb. 8, 2018

The Dow Jones Industrial Average and S&P 500 entered correction territory for the first time in two years on Thursday as worries about rising interest rates and newfound volatility continued to rattle the markets.



The Dow hadn't been in a correction—a decline of at least 10% from a recent high—since February 2016.

... stocks' losses escalated near the end of the trading day, with the blue-chip index falling more than 400 points in the final 30 minutes of the session.

The Dow ended down 1,032.89 points, or 4.1%, to 23860.46. The plunge marks the second-steepest point decline on record, after Monday's 1,175.21-point swoon. ...

The S&P 500 fell 100.66 points, or 3.8%, to 2581.00 and is now down more than 10% from its record close on Jan. 26. The Nasdaq Composite dropped 274.82 points, or 3.9%, to 6777.16 and is off 9.7% from its recent high, also on Jan. 26.

Some money managers speculated that the market continues to be pressured by a crash in volatility-related bets from earlier in the week when investors, who piled into funds and vehicles that bet against market swings, contended with steep losses. Volatility returned in force to the market this week as Wall Street's fear gauge—the Cboe Volatility Index, or VIX—posted its biggest-ever one-day percentage increase. ...

Thursday marked the fifth consecutive session that the Dow swung more than 500 points intraday from its high to its low. ...

The yield on the 10-year U.S. Treasury note rose to 2.851%, near its highest level since early 2014 ....

Shared by one of our DIYers. Ian Wyatt:

Don't Sweat the Roller Coaster Ride for Stocks

Thursday, February 8, 2018

The last week has seen a dramatic return of volatility to the markets.

Last Friday, I gave you an update on the latest jobs report that sparked a decline in the major indexes. ...

However, on Monday, we saw the Dow plunge 1,175 points in a single session. This was the largest decline in terms of points in a single day. However, it was dwarfed by previous crashes such as Black Monday in 1987 when the Dow lost 22.6% in a single day.

During the lows on Monday, the Dow was down 8.5% from its highs. That means technically the market didn't even enter a "correction" – defined as a 10% to 20% decline.

It also means that the market has simply given up the gains from the month of January. And it's a long way from a stock market crash, which is a drop of greater than 20%.

With the market's decline, we've seen a huge increased in volatility, as tracked by the Volatility Index (VIX). Even intra-day, we've seen huge price volatility. For example, on Tuesday the Dow opened sharply lower, bounced back and forth throughout the trading session, and ended the session sharply higher.

What we are seeing right now is a normal return of volatility to the market. ...

Volatility = Normal

It's important to remember that financial markets are normally volatile. It may be hard to remember, but down days (or even weeks and months) for the major market indices are actually common – and healthy.

Since the year 1900, there has been a correction once per year (on average). Yet 75% of the time, the market managed to deliver a positive annual gain, despite the correction.

The simple fact is that we've been in a (secular) bull market since early 2009. And in the last couple years, the market has continued to grind higher, month after month.

That's in turn made most folks pretty complacent. And it makes any deviation from the normal feel really unusual, and uncomfortable.

The following chart is a good reminder that market declines happen frequently.

Market Downturns Happen Frequently and They Don't Last Forever
Dow Jones Industrial Average 1900-2015

	-5% or more	-10% or more	-15% or more	-20% or more
Average Frequency[1]	About 3 times a year	About once a year	About once every 2 years	About once every 3.5 years
Average Length[2]	46 days	115 days	216 days	338 days

[1] Assumes 50% recovery of lost value
[2] Measures market high to market low
The Dow Jones Industrial Average is an unmanaged, price weighted average of 30 actively traded industrial and service-oriented blue chip stocks.

Prior to this week, the market hadn't had a 5% pullback in nearly two years. As you'll see in the chart above, that typically happens three times per year. That was the longest stretch in nearly 20 years.

Meanwhile, the S&P 500 had posted positive gains in each of the last 15 months – a feat that's occurred just once before, in the year 1960.

Until the last two weeks, volatility was completely nonexistent.

We know that making abrupt moves in response to the market can be costly. Not only is timing the market impossible, but selling stocks at the wrong time can significantly damage an investor's long-term returns.

From 1997 to 2016, for example, the S&P 500 had an average annual return of 7.7%. An investor who missed just the best 40 days during that span would have suffered a 2.4% annual loss.

That means the RISK of moving to the sidelines – and missing a rebound – can have a huge negative impact on long-term portfolio returns. ...

The U.S. economy is healthy. Consider the low unemployment, healthy GDP growth and double-digit quarterly earnings growth. All signs point to a robust economy – not one on the brink of a recession. ...

The Stock Market Didn't Get Tested—You Did

The calm over the past few years set investors up for a shock

By *Jason Zweig*
Feb 5, 2018

Stop trying to make sense of the stock market.

The one question every investor was asking on Monday has no answer: Why? Why did the Dow Jones Industrial Average close down nearly 1,200 points, or 4.6%?

Market commentators are already arguing that stocks were bound to fall because interest rates are rising and inflation is sure to jump as the economy heats up. But a week or two ago, before stocks stumbled, analysts were saying just as glibly that moderate increases in interest rates and inflation were good for stocks.

Yes, stocks have been expensive by historical measures for some time now. And investors have been extraordinarily optimistic. In January, near-term earnings estimates for the companies in the S&P 500 rose by the largest percentage since 2002, according to FactSet.

What's more, the abnormal smoothness of the stock market over the past couple of years set investors up for a shock whenever stocks did fall at least 5%, as they did on Monday. As I pointed out last month, in the low-volatility market we've seen until recently, "even slight declines are apt to set off talk of Armageddon, and you will need to focus harder than ever on long-term returns to keep short-term losses from rattling you."

That's because the pain of a market drop depends not merely on its size, but on its steepness relative to recent experience. A 5% drop back in late 2008 or early 2009 was almost routine; now it feels like a frightening deviation. ...

But just as no one knows, to this day, why the stock market crashed in September 1929 or October 1987 (As I cover in my Advanced Topics in Investments class, this isn't accurate. Over-leverage in both crises played a significant role (particularly 1929), and it is very well documented that Portfolio Insurance was the main contributing factor to the 1987 crash.), searches for a rational explanation of Monday's madness are futile. ...

That's what markets are like. Tens of millions of people don't always act rationally in response to new information; often, they react to nothing but how they think other people are acting or will act. Logic can melt into emotion in the blink of an eye.

Monday's madness is a reminder that investing in stocks doesn't automatically make people rich. Twice in the past 20 years—between 2000 and 2002, and again between 2007 and 2009—the stock market has cut investors' wealth roughly in half.

No one can say when that will happen again, but everyone should know that it can—and very well might. If a 6% daily drop makes you squirm, then you probably have too much invested in stocks for your own psychological good.

One of our favorite Buffet quotes: **"The market, like the Lord, helps those who help themselves. But, unlike the lord, the market does not forgive those who know not what they do. "** Also from Friday's journal:

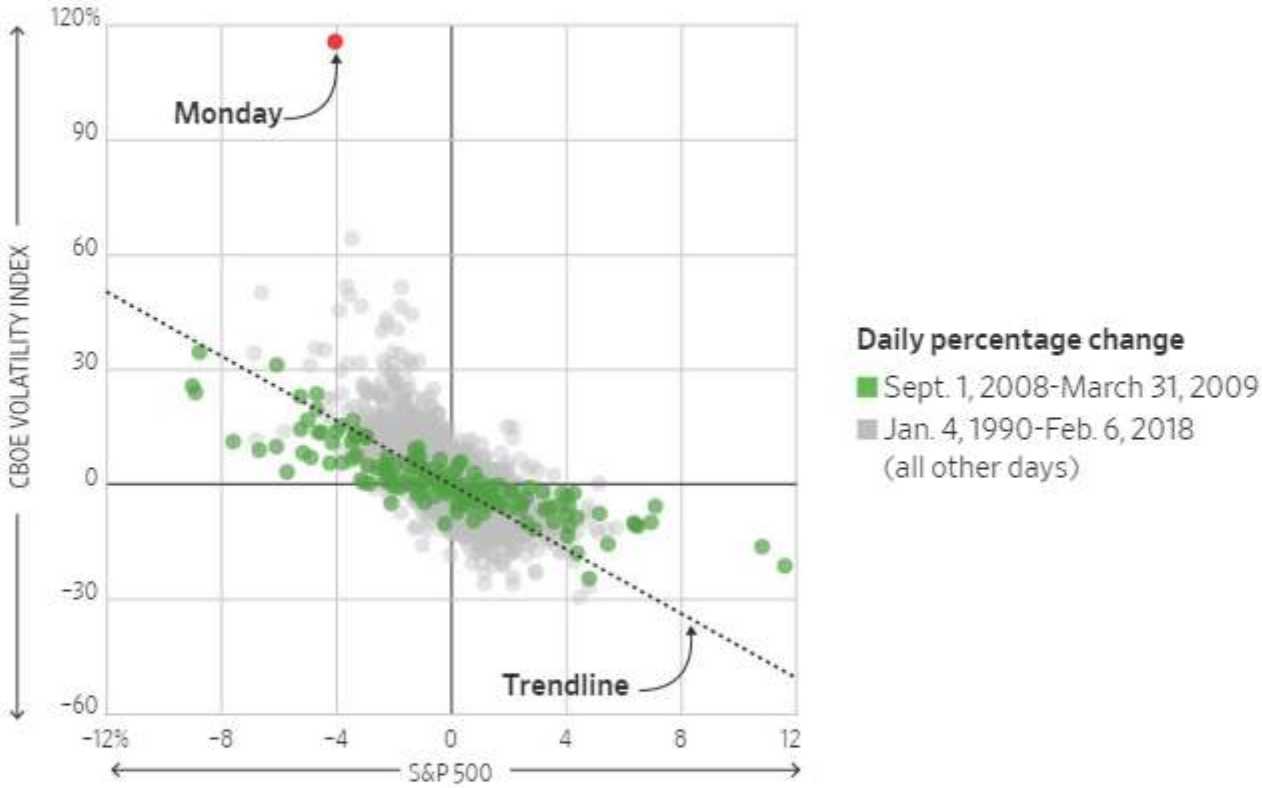
By James Mackintosh
Feb. 8, 2018

The relationship between volatility and stock prices broke down spectacularly this week ....

There is a strong historical link between the S&P 500 and the Cboe Volatility Index, or VIX. When the VIX goes up, shares go down, by about one-quarter as much. Luckily for shareholders, on Monday that link snapped. Had the S&P fallen in line with the long-term pattern, shares would have plunged about 27% on Monday when the VIX more than doubled in a day for the first time. Instead, the S&P 500 dropped 4.1%. ...

VIX Breakdown

The relationship between stock price moves and volatility broke down on Monday in a way not seen even during the Lehman panic.



Source: Thomson Reuters Datastream

On Thursday, the link between stocks and volatility was back to something resembling normality, with the VIX climbing 21% and the S&P off 3.8%.

The soaring VIX was in large part down to what investors call technical factors, in this case the implosion of multibillion-dollar structured products that bet on volatility staying low. The VIX above 50 spelled doom for stocks in 2008, but this week it was merely about products that were designed to die suddenly meeting their destiny. ...

The XIV and similar structures are now tiny (and dying) .... But pension funds and other long-term investors have piled into strategies that bet against volatility, in effect selling insurance against market downturns. The wager is that the insurance premium—the money from selling options—makes enough in the good times to cover the sudden nasty losses when the market falls. ...

XIV was designed purely for intraday hedging, and the buyers piling into it for longer periods were a perfect example of complacency. Its prospectus included bold, underlined warnings that its long-term expected value was zero.

When structured mortgage bets brought down two Bear Stearns hedge funds in 2007, many investors and central bankers also reassured themselves that the wider economy was fine. They were proved catastrophically wrong in 2007, and there are plenty more products with a similar structure to XIV out there, including two-times leveraged long volatility products with the same bold, underlined warnings.

But not every complex fund collapse is a sign of deeper trouble ahead. The 1994 bond rout took down the highly leveraged Granite hedge funds, but the economy sailed through. In 1998, the far bigger failure of Long-Term Capital Management—and a string of emerging-market defaults—proved little hindrance to the expanding stock-market bubble. XIV's success was a clear sign of market excess, but its failure isn't necessarily a sign of an imminent crash.

Steamrollered

Betting against volatility is often likened to picking up pennies in front of a steamroller. The XIV exchange-traded note was crushed this week.

VelocityShares Daily Inverse VIX Short-Term ETN

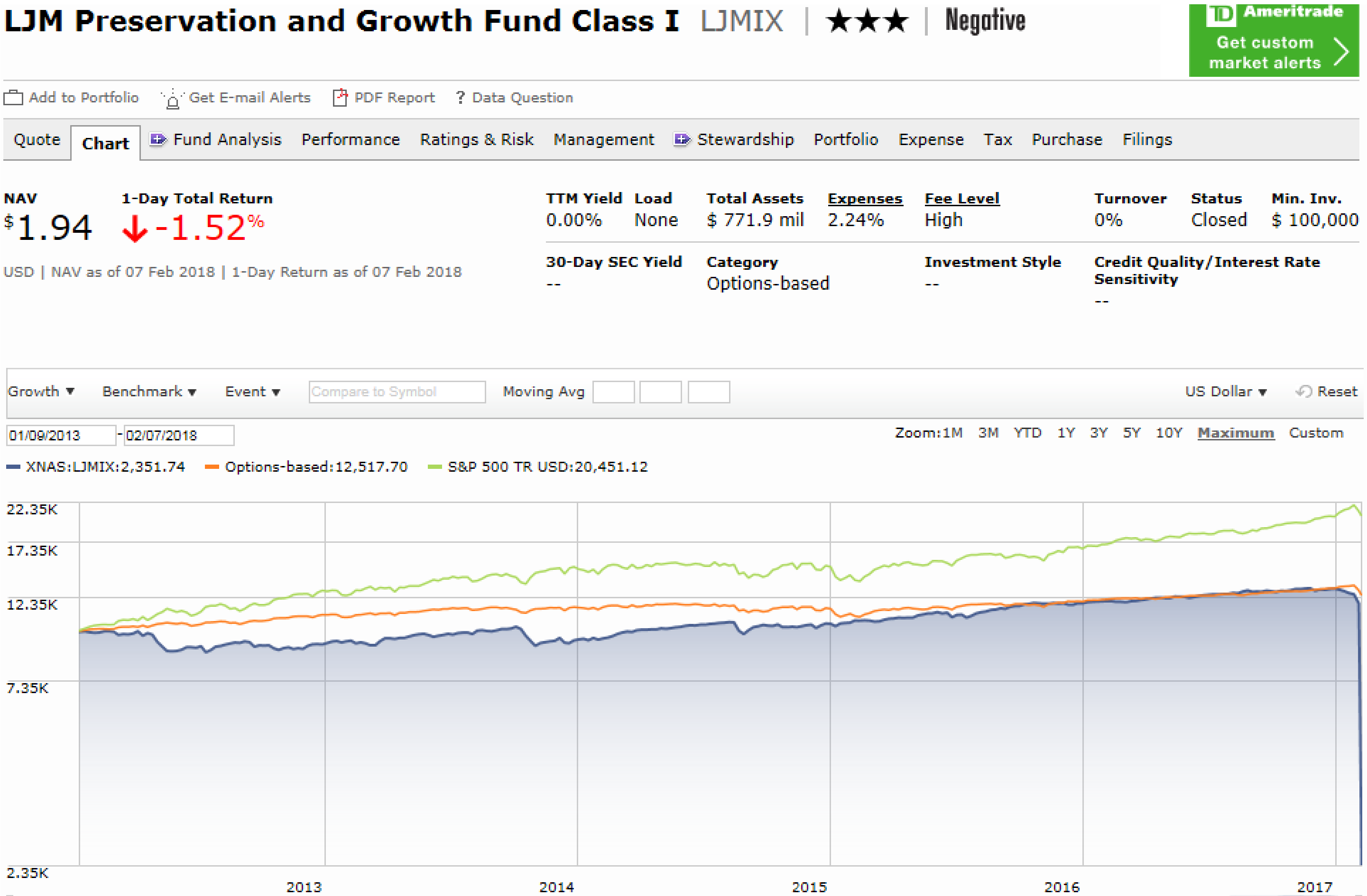
Note: Daily data through 11 a.m. EST, Feb. 8
Source: Thomson Reuters Datastream

Another example came from Morningstar's John Rekenthaler on Friday:

In Wall Street parlance, the investor who writes out-of-the-money options picks up nickels, at the risk of being squashed by a steamroller. The profits that accrue from selling out-of-the-money options are frequent and small (understandably, buyers don't pay much for options that are unlikely to pay off). The losses are infrequent, and sometimes huge. In fact, if the positions are not monitored carefully, a surprise market move can be ruinous.

As was the case this week with LJM Preservation and Growth fund (LJMIX), which, as you can see below, failed on its name. As of this writing (Thursday, Feb. 8), the fund's one-week trailing total return is negative 81%. This is an inauspicious result for a fund that puts "preservation" on the wrapper. Also, this wasn't a case where a fund lost a lot of money on paper, but nobody actually owned it. The LJM Fund had almost $800 million in assets at last report. Not so much anymore. (It should be noted that Morningstar's analyst lowered her rating to Negative from Neutral on 2/9/17, after this OEFs "demise".)

Specifically, the LJM Fund shorted stock-market volatility. That was not a good place to be this past Monday. Once again, Tayfun called it, only this time back in July 2017: "Track records [from option-writing funds that short volatility] can look very attractive for a while, with high income and high Sharpe ratios. But hidden tail risks can cause large unexpected losses during the next big spike in volatility." Indeed they did.



Our thoughts

How HCM's clients have done during the Correction (1/26-2/8/18), so far, can be seen in the table below. Two of our 8 clients have portfolios designed to maximize Capital Appreciation. Their losses, as shown in column 2, were slightly less than the S&P 500's 10.2%. The remaining 6 clients have portfolios designed to reduce **Risk,** as measured relative to the S&P 500 during declines of at least 10% according to the ratio shown in column 1. Their actual Relative Drawdowns compared to the S&P 500 are shown in column 3. All of them performed better than their risk ratios would have predicted. These results were achieved without an allocation to bonds ("Return-free risk") or Cash (Dead money), and compare favorably with the ubiquitous 60/40 portfolio's 6.5% loss during this period (60% S&P 500 / 40% Barclays Capital U.S. Aggregate Bond Index).

Risk (1)	**DD** (2)	**RD** (3)
CA	-10.1%	1.0
CA	-9.8%	1.0
1.1	-8.6%	0.8
1.0	-8.8%	0.9
1.0	-7.3%	0.7
0.9	-7.1%	0.7
0.8	-6.1%	0.6
0.5	-3.3%	0.3

1 Ratio of average historical Max. Drawdowns to S&P 500 declines of at least 10%

2 Drawdown from 1/26-2/8/18

3 Relative Drawdown to the S&P 500's -10.2%

CA=Capital Appreciation accounts w/o **Risk** mitigation

For HCM, there are at least three keys to successful investing:

1. Getting your Risk Profile right. As "Adam Smith" said of the stock market in his classic book "The Money Game": **"If you don't know who you are, this is an expensive place to find out."**

2. Designing a Quantitative, Factor-driven portfolio that matches your Risk Capacity & Tolerance. **“To break from our all too human tendencies to**

avoid losses even when it is disadvantageous to do so, chase performance, and perceive patterns where there are none, we must find an investment strategy that removes subjective, human decision making from the process and relies instead on smart, empirically proven systematic strategies. …we can become wise by realizing just how unwise we truly are." - James O'Shaughnessy, from the 4th edition of *What Works on Wall Street*

3. Understand what you're investing in, and, if you don't, find someone that does. **"It's like somebody who plays Russian roulette three times in a row without the gun going off, and thinks they're great at Russian roulette. The fourth time, they blow their brains out.**" - Daniel Loeb, founder of $9 billion hedge fund Third Point