Investment Insights

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Markets are Becoming more Volatile- What Should Investors do Now?

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Let's be honest - investors despise price volatility. Whether it is the sharp decline in oil prices, bond yields plunging to all-time lows, or stock prices enduring sharp one-day price swings, it all tends to increase investor anxiety. At Tandem, we have believed that market volatility would likely increase as the Federal Reserve works to unwind several years of quantitative easing. While we have seen short spurts of volatility during the past few years, it is only recently that volatility has increased on a noticeable and sustained basis. This increased volatility makes many people more concerned about their investment portfolios.

Volatility is a summation of the potential risks facing investors along with their levels of fear/greed. As the amount of economic and geopolitical information available increases exponentially, many investors instinctively react to the latest information – positive or negative – and this helps contribute to market volatility. Looking at the economic, geopolitical and fundamental issues in both the US and internationally, we believe that volatility levels should be higher than they had been over the past few years when the Fed's suppression of interest rates helped to dampen overall volatility. Risk levels haveincreased a bit, but not enough to warrant large swings in market prices. The biggest concern currently is how the Fed will reduce its balance sheet and begin to raise interest rates. While this is a legitimate concern, the largest driver of equity prices has always been corporate earnings which are driven by economic growth in the US. We do not see the likelihood of a recession in the US economy over the next 12-18 months so we believe the downside risk in equity prices is modest from current levels. There have been large price swings in commodity prices, bond market prices and currencies over the past 12 months. Some investors believe this higher volatility has to flow into the equity markets, but we think they are only partially correct. Volatility in equities has increased and will likely stay at levels more elevated than in the last few years. However, volatility seems to be moving from the overall market level to the sector level where individual economic sectors see large price movements up or down. As one sector declines and another rises, the overall market volatility increases only slightly. For 2015 through mid-May, the percentage of days in which the Dow Jones Industrial Average rose or declined by 1% or more from the prior close is about 30%. While higher than the10-15% we witnessed from 2012-2014, this is still well below the 50% plus we saw in 2008-2009.

While investors would like to see the value of their portfolios climb steadily and inexorably higher, we know that is not the case. Capital markets move up and down - sometimes quickly and sharply - but historical analysis tells us that equity markets rise at a long-term average rate of 8-10% annually. We believe volatility is not only normal in the capital markets, but can be used to positively benefit client portfolios if used properly. If fundamentals remain intact, we would utilize excessive downward price movements as buying opportunities rather than a reason to sell positions.

At Tandem, we focus on risk management. This begins with an appropriate asset allocation for each individual client based on his or her specific situation and needs. While many firms group clients by asset levels or ages, we believe in discerning the proper asset allocation for each client and then reviewing this asset allocation on a regular basis as each person's situation may change over time. Having a proper asset allocation helps to control downside risk and allows clients greater peace of mind. One of our favorite maxims is that our crystal ball is much clearer three years out than three weeks. Being a successful investor does not depend on predicting the short-term future. Sticking to a well-designed asset-allocation with the discipline to wait out volatile periods leads to better long-term returns than frequent trading based on emotion. Short-term market swings are driven on waves of fear and greed, rather than underlying economic drivers. Over the longer-term, economic and fundamental factors override short-term emotional swings.

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