Volatility? Your IPS Is Your GPS

Given the tranquility seen in global financial markets over the last year and a half, investors might be feeling a bit "lost in the woods" when volatility spiked and asset values plunged in the final week of January and first week of February.

Prior to that 10% peak-to-trough drop from January 26 to February 8, the S&P 500 index had not seen a drawdown of more than 3% in 308 trading days, the longest such stretch in the post-WWII era. It had been 400 trading days since the last time markets declined at least 5% (within two weeks of the record set back in the late 1950s) and fully 494 trading days since there was a drop of 10% or more (that trough was turned in on February 11, 2016).

So, while recent history may have suggested that calm is the norm — where markets go straight up uninterrupted (2017 was the first calendar year on record where the benchmark U.S. equity index did not post one negative monthly return) — it is actually the case that this period was exceedingly out of the ordinary.

Some market volatility is normal as new information comes to the fore and sentiment ebbs and flows, taking risk appetite with it. And while painful to those exposed to them, these types of corrections are part and parcel of bull runs — they represent an opportunity to clear the froth and reset for the next leg higher.

And to be clear, this recent spasm in markets was pretty much a textbook correction (which typically occur every couple of months instead of years) rather any sort of market-wide inflection point. It was not predicated on any signs of fundamental weakness in the stock market — earnings expectations are being revised higher and more than one-fifth of stocks in the S&P 500 have announced dividend increases so far this year, with the average hike being a robust 14%. Nor was it a function of a softening economic backdrop — and a fundamental bear market needs a recession which causes earnings to crater; the current macro outlook, not just in North America but across the globe, is healthy with no real indication that a recession is imminent.

Instead, the recent market action was a function of a rapid shift in what was excessively bullish and historically complacent investor sentiment that was likely compounded by some structural elements within the market (for example, the increasing prevalence of instruments like exchange-traded funds can exacerbate these types of swings).

It is easy to let emotion get the best of you in moments of broad-based market turbulence and follow the panicked herd by indiscriminately selling assets. A seasoned investor, however, knows it is better to keep a cool head in these situations and not risk permanently impairing a portfolio's capital by selling at the bottom. Moreover, they recognize that these periods represent buying or rebalancing opportunities — the good assets are not "worthless", just "worth less" meaning that investments can be made at even more attractive valuations which sets up better return prospects when markets rebound as they typically do in fairly short-order.

Despite what recent history may have suggested, volatility is an unavoidable part of the investing process. The prudent investor will learn to accept, if not embrace, volatility in the pursuit of their long-term financial goals. When these market gyrations leave you feeling slightly lost, let your Investment Policy Statement (IPS) serve as your GPS that will, along with your Portfolio Manager, get you to where you are going. Do not let the detours, diversions and distractions that global markets continuously present get in the way of your destination.