



## The Return of Volatility

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By any measure financial markets have been calm over the last several years. The recent price volatility has many investors concerned. As is the case when markets get bumpier, this worry is fanned by the media. Headlines like “Market Plunges 100 Points!” helps sell newspapers but doesn’t do much to add helpful context! 100-point market moves sure sound scary, but historically fluctuations such as this are common. This note briefly examines historical volatility and attempts to put recent market fluctuations into context.

*“We think it’s important to remind our clients to keep their eyes on the horizon. Long-term profit growth and dividends have and will continue to see investors through market turbulence.”*

The Dow Jones Industrial Average (DJIA) is the benchmark most quoted by the mainstream media when reporting about the stock market. Table 1 illustrates the size of various point changes in the DJIA over the past 30 years. In 1985, a 77-point drop equaled a loss of 5%. To get a 5% loss in 2014, the DJIA has to fall 822 points. The value of a 15-point drop in 1985 is equal to a 164-point drop today. Note to the media: a 100-point drop in the DJIA isn’t what it used to be!

**Table 1**

Year	5% Points Change	1% Points Change
1985	77	15
1995	256	51
2005	536	107
2014	822	164

Source: HM Payson Research Department

As of the time of this writing the S&P 500 has fallen approximately 7% from its all-time high set in mid-September. This is a significant drop in a short time period. The drop does not seem as large, however, when put into context with the total returns of the bull market that started in March 2009. Table 2 shows the cumulative total returns of various domestic and international equity benchmarks for comparison. From the market low on March 9, 2009, the S&P 500 returned 234%. The market hasn’t given much back so far.

**Table 2**

Index	Cumulative Total Return	
	3/9/2009 to 9/18/14	9/19/2014 to 10/13/14
S&P 500	234%	-7%
Russell 2000	264%	-8%
MSCI Emerging Markets	155%	-6%
MSCI EAFE	156%	-7%

Source: HM Payson Research Department

### Market Log-

October 21, 2014

S&P 500: 1,941.28

10 year T-Note: 2.22%

Crude Oil: \$82.76

Gold: \$1,246.80

If you have questions or comments regarding this or any other communication from us, please email us at: [hmpresearch@hmpayson.com](mailto:hmpresearch@hmpayson.com).

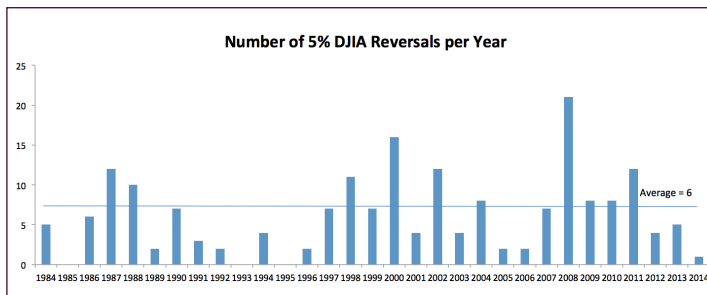
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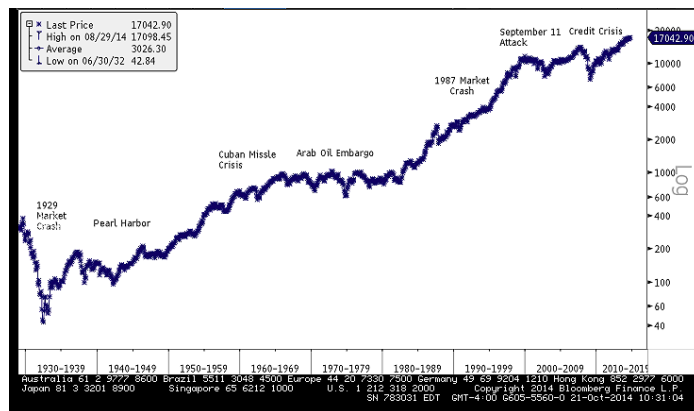
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Historically speaking, the *lack* of volatility over the last several years has indeed been abnormal. The graph below illustrates this point. It looks over the last 30 years at the number of 5% reversals the market experienced in each year. In this graph a reversal is defined as the market dropping 5% or more over consecutive negative days. In fact, we have experienced only one of these events in 2014. The market has averaged 6 such reversals annually over the past 30 years. As a comparison, in 2008 the market had 21 of these 5%+ reversals!



Source: HM Payson Research Department

There are several possible explanations for the recent increase in market volatility. Data suggests global economic growth is slowing; Europe appears to be falling back into recession. And, geopolitically, the unnerving rise of ISIS and the frightening spread of the Ebola virus into the US have engendered fear and uncertainty – which markets dislike. The graph below looks at volatility over a longer time horizon. Going all the way back to 1928, we overlay the DJIA with some significant historical events. This graph is a good reminder that there has always been volatility; but over time the price trends upwards.



Source: HM Payson Research Department

[1] The Volatility Index or VIX it is a mathematical measure of how much the market thinks the S&P 100 Index option, or OEX, will fluctuate over the next 12 months, based upon an analysis of the difference between current OEX put and call option prices.  
See more at: <http://www.hmpayson.com/the-return-of-volatility>

Long-term oriented investors can use volatility to benefit their returns. Table 3 illustrates returns for different levels of the Volatility Index.[1] Forward market returns are much higher when the volatility index is high. The average annual gain for the market is almost 14% when this index is 20% above its one year average. Volatility creates opportunity!

Table 3

Volatility Index Level	Gain per Annum
20% Above 1 Yr. Average	13.80%
Average	3.80%
20% Below 1 Yr. Average	2.50%

Source: Ned Davis Research

In the very short run, stock price movements account for virtually all of the market's return. Growing profits and dividends explain a larger and larger part of the market's return as the holding period moves away from the short run. For more than a year we have been concerned about high valuations and the low Volatility Index.

Even though recent downward market price volatility has delivered improved valuations, our expected returns for most asset classes remain low, both absolutely and relative to long-term historical average returns. Our research process focuses on finding businesses capable of generating and compounding cash flows.

We buy the stocks of these businesses at prices we believe will give us an opportunity to earn reasonable returns. Short-term volatility often provides us the opportunity to build positions in companies with strong fundamentals and reasonable valuations.

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