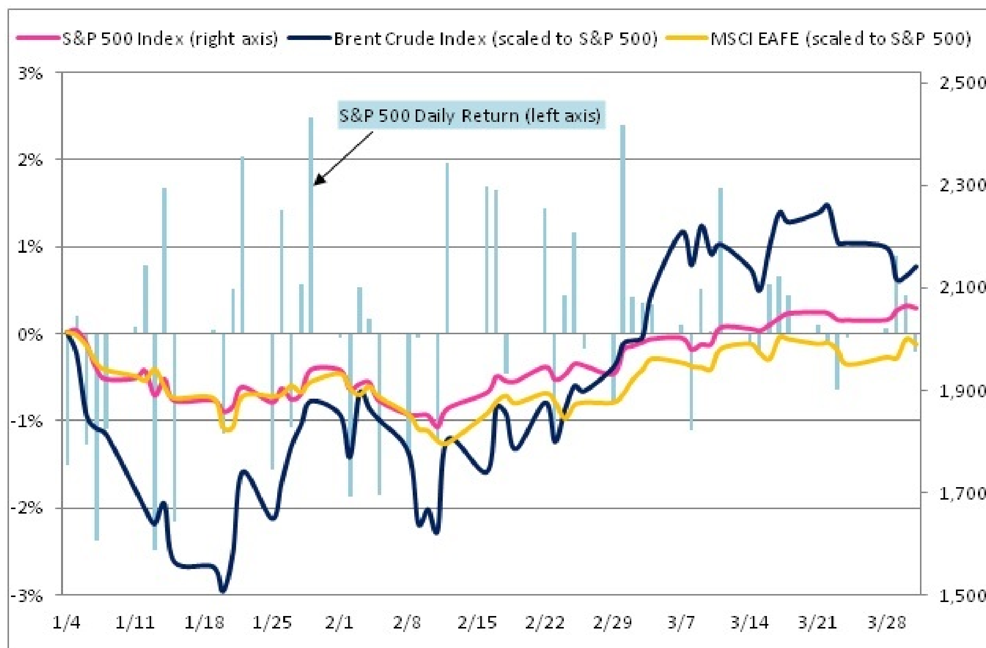
Yo-Yo Market or Yo-Yo Ma

If you found yourself biting your finger nails, waking up in the middle of the night or fidgeting this past quarter you would not be alone. The markets were unnerving. Volatility is back! Like a yo-yo, the S&P 500 went down 9% early in the quarter then up 13%, ending the quarter +2%.

So what's the worry? When markets follow this yo-yo movement, they are generally driven by macro events and sentiment which can vacillate between fear and optimism. We experienced considerable uncertainty and fear in January and February as concerns about the Chinese economy, oversupply of oil and other commodities, terrorist attacks in France/Belgium, strength of the US dollar, the Fed's next move, weakness of European banks, Chinese currency devaluation, militarization of the South China Sea, etc. caused markets to fluctuate wildly. Oil appeared to be the primary victim of the yo-yo market as the price of Brent Crude slid 25% early in the quarter and rebounded 42% for a 6% overall gain. Volatility as typified by the S&P 500's daily return (shown in light blue bars in the chart below) exceeded +/-2% several times in the quarter, only to subside in March.



Oil oversupply concerns, reflecting too much production and/or a slowing global economy with decreased demand, drove most of the early market decline. But as the quarter progressed, these concerns dissipated as more data on the slowdown in US drilling became available and analysts could forecast a time when supply and demand would synchronize at a much higher equilibrium price. As worries about oil receded, continued positive economic news and sentiment data in the US, as well as expanded quantitative easing by the ECB, drove markets upward. A weakening US dollar against a number of currencies including the Euro and the Brazilian Real also contributed to the bounce that occurred in the second half of the quarter.

International markets represented by the MSCI EAFE followed similar volatility, down 11% and up 11% to end the quarter -1%. The weakening dollar dampened the bounce at the end of the quarter. Emerging

Markets recovered some previously lost ground to end up 5.8%. The 10 year Treasury yield dropped 33% from 2.7% to 1.8%, thus buoying bond returns for the quarter.

A Return to Normal Volatility

Can we expect more volatility in the future? The simple answer is yes. Our experience from July 2012-July 2015 was one of unusually low volatility. The average volatility for that period, as measured by the VIX (Chicago Board Options Exchange volatility index), was 30% lower than the 23 year average as well as 30% below this quarter's volatility. We may be entering a new period of increased volatility accompanied by lower growth prospects.

While volatility is uncomfortable for most of us, it can be a good thing for active managers, particularly those that are focused on risk as well as return. Active managers often see volatility as an opportunity to buy the stocks of fundamentally strong companies when their stock prices have been punished by unwarranted fear. This may also be a time when stock picking based on solid fundamentals prevails over passive strategies.

What to do? Proper diversification can lower portfolio volatility

Looking at the chart below, the S&P 500 index is shown as the gray bar running through the center of the chart with other asset classes lined up either above or below on the basis of return for the given years. For years 2013, 2014 and 2015, the S&P 500 index was a star performer. That must be the place to be, right? However, there are times that the S&P 500 is at the bottom of the pack (2002), and in 2016 so far it has returned to the middle where it tends to hang out for much of the time.

Source: Goldman Sachs Asset Management, April 2016 Market Pulse, data as of 3/31/2016

A time tested method for mitigating volatility and building wealth over the long run is to create a portfolio of assets whose price changes tend to offset each other – in other words – diversification. When your portfolio is well diversified, the amount of volatility you experience can be significantly less than what you would see in the individual markets.

According to JP Morgan Asset Management, over the past 15 years, the annualized return of a diversified portfolio was 5.7%, 1.6 percentage points higher than the S&P 500 Index return of 4.1% and its volatility was lower, with standard deviations of 11.2% versus 16.7% respectively.[1] Developed international markets turned in an even lower return for the 15 years, up only 2.8% with a standard deviation of 19.6%.

So if you have built an "all weather" portfolio with managers who focus on risk as well as return, when volatility rears its ugly head you can put on Yo-Yo Ma's *Songs of Joy and Peace*, close your eyes, breathe deeply and visualize your happy place.

[1]JP Morgan Guide to the Markets, U.S. 2Q 2016 As of March 31, 2016 Diversified portfolio comprised of 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Barclays Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Assumes annual rebalancing. Volatility represents period of 12/31/99 – 12/31/15.