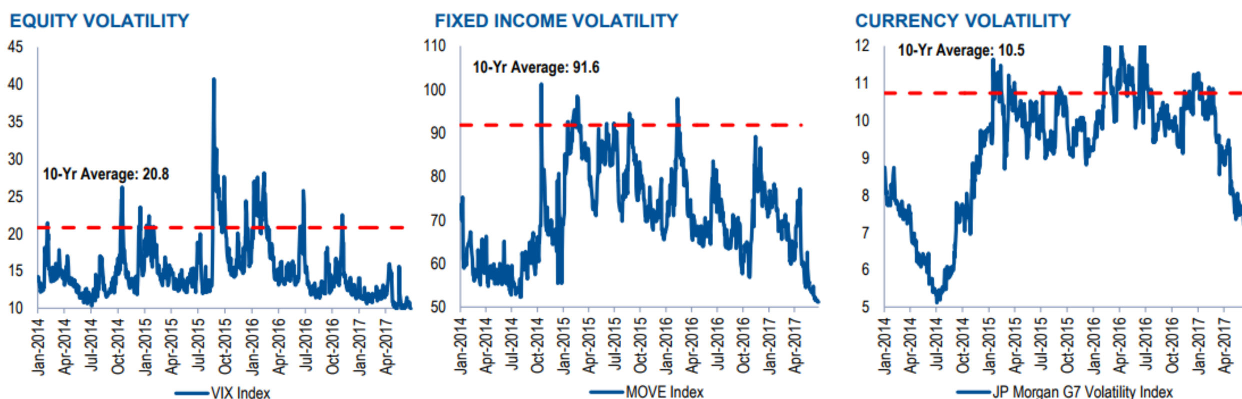
Double, double toil and trouble,
Fire burn and caldron bubble.
William Shakespeare, from Macbeth

Is the stock market bubble getting ready to burst… again?

At our monthly Waypoint Investment Committee meetings, in addition to taking a good hard look at our portfolios, we also talk about what we all are seeing and hearing in the real world. "Where is the next bubble?" we keep asking ourselves.

Last month, one of our committee members related that on a recent sunny Sunday afternoon while sitting on the beach, a friend leaned over and out of the blue asked her what we were investing in these days. "The market is so high," the friend said with worry in his voice, "and it keeps going up. Where should I be putting my money?"

It's true that in the first two quarters of 2017, the U.S. equity markets performed well with 9 of 11 sectors posting positive returns and the S&P 500 returning 9.3% year-to-date. Buoyed by the promise of lower taxes and fiscal stimulus, by slow but steady economic progress, and by positive economic and political news from overseas, the markets have barely wavered. Normally, unsettling news such as coup attempts, missile tests, terrorist attacks and conflicts in the Middle East would be followed by a certain period of volatility. But instead, volatility across major U.S. assets classes has been extremely low with equity, fixed income and currency volatility indices well below their 10 years averages.



Source: Neuberger Berman, Bloomberg. Daily data January 2014 – May 2017. For illustrative purposes only. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

What's with this low volatility? Isn't this a good thing?

The issue of volatility is puzzling. It seems strange that prices have remained this high for this long without some kind of a correction. Recently, an article appeared in the *Wall Street Journal* describing how a day trader in Florida had made a big hunk of money this year by "shorting" the CBOE Volatility Index, nicknamed the VIX.[1] The article referred to the VIX, which was "created to track expectations of volatility," as Wall Street's "fear gauge." The article noted that just as the S&P 500 has reached all-time highs, the VIX "has neared all-time lows."

The WSJ goes on to report that "lately, the VIX has been signaling a near-complete absence of fear, and the preternatural calm is making some people nervous. Opinion is divided on whether it is a bullish signal for stocks or a worrying sign of complacency. After all, the VIX also approached a record low in 2007, just before the subprime crisis began unspooling."

Silly Rabbit, VIX are NOT for Kids

Should we be concerned about the apparent contradiction between the uneasiness we feel and the low level of the "fear gauge?"

Volatility has been kept at bay for many reasons. The economic recovery, while not robust, has been steady and market spikes have been few and far between, with the market returning quickly to its tortoise-like path. In addition, the popularity of passive and algorithm based investing may be tamping down volatility due to the automatic robo-nature of these strategies.

What will happen if the VIX starts hopping off its all-time lows and real volatility comes back into the market? Will we be chasing that rabbit right down the rabbit hole?

But, prices are high and volatility is low… should I be worried?

This question epitomizes the dilemma created by this unusual period of high valuations and low volatility and the emotional uneasiness that seems to be accompanying such a dichotomy. Is the market going to continue to go up even further, we wonder? Or is it going to start falling off the cliff?

Fixed income markets also offer little respite as the Fed's path towards higher interest rates has been well telegraphed. And, while passive investments can seem attractive at times like these, many of these strategies merely mirror an index and are untested in a difficult market, potentially exacerbating a decline when the markets start reversing.

And what about alternative investments? Which strategies make the most sense and why?

What's an investor to do?

Since we can't predict if and when the market may change its course, we think the best thing to do is to review again some basic guidelines of investing:

- Develop a good game plan and stick with it for the long run.

- While you should review your investments on a regular basis, making decisions based on short term results and trying to time the market can be hazardous to your long-term success.

- Remember that uneasiness can be a signal that change is coming. Don't make impulsive or emotional decisions. They often result in the wrong choice at the wrong time.

- High quality active managers build portfolios that can protect you when times get rough. Losing less when the market goes down means that you may recover faster when the market goes back up. Active managers also tend to hold more cash when stocks get pricey which allows them to take advantage of corrections as they occur.

- Phase in cash strategically. Consider dollar cost averaging into the market and adding money first to those investments that are best positioned to hold up well as volatility increases and the market sells off from its high level. Set aside any cash needed in the next 12 – 18 months.

- There are no sure-fire silver bullets in the investing world. High quality investments beat low quality investments over the long run. Be wary of any strategy that seems too good to be true.

- Volatility can actually be your friend when your portfolio is periodically rebalanced.

- Finally, remember that a well thought out, well diversified investment strategy built to weather all types of market conditions can provide the best peace of mind.

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[1] Wall Street Journal, June 12, 2017, *The Snowballing Power of the VIX, Wall Street's Fear Index.*