Manulife Securities

A Few Words on Recent Market Volatility

In my last few newsletters, I have been warning that we should see at least a 10% correction on the U.S. stock market because prices were getting a little frothy and because the U.S. was nearing a record length of time for not having at least a 10% correction. In January/February the U.S. markets did finally drop by slightly more than 10%. And of course the Canadian market dropped almost as much. Some of the sell-off in the market was due to fears of rising interest rates, which we have all known for years would be coming.

I was pleased to see that virtually all of the funds I support fell far less than the market. It seems that quality stocks bought at reasonable prices didn't suffer like the more overpriced stocks. About 20% of the top 100 stocks in the U.S. fell over 20%, while our equity funds (those holding stocks) generally fell between 2 and 6%. As I write this, the U.S. market has half recovered to only be down 5% from their peaks and the client portfolios I have checked are between about 1% down and 2% up!

Even better is that several of my favourite fund managers had 25-40% cash at the time of the market correction. Those managers had a chance to use that cash to buy up stocks when they became better priced during the correction. That should help their funds get extra returns in 2018. Holding all that cash last year however did hold down the returns on those funds in 2017. Often the value style will underperform during hot markets and then later prevent losses when the market turns down. This makes for a smoother growth path and traditionally results in long term outperformance for the value style. Let us hope that that is the result again this time.

One reason this recent volatility scared many investors so much is that we have become unaccustomed to much volatility. In 2017 the US market volatility (on the S&P 500) was only 3.9% and on the TSX (the main Canadian stock index) it was only 4.4%. The historical average for volatility over the last 20 yrs has been 14.9% for the S&P 500 and 13.9% for the TSX (per RBC Global Asset Management). So based on history, we could reasonably expect much more volatility in the future like we have seen this year so far. And pity the poor people who were betting on continued low volatility in the market. Those who owned SVXY, which prospers if short term volatility is low, saw their holding rise in 2017 from just over $50/future to just under $140 and then in 2018 tumble to under $12 in early 2018 (per Bloomberg courtesy of Templeton) for an 84% drop from the initial investment.

Those who invested in cheap ETFs which try to clone the market also fared less well than the market itself, let alone investors in actively managed value funds. The largest index ETF in the world, commonly called the SPDR (pronounced spider) S&P 500 ETF fell 11.7% at one point while the actual S&P Index fell about 10.2% at its worst (from the high on Jan 26 to the low on Feb 8). I expect many ETF investors were surprised to see the performance of the ETF be so disconnected from the actual market performance.

Rather than being scared of the volatility we should remember 2 things. First, our value managers lover volatility. It means that prices get too high and our managers can sell in those markets, and then the markets drop too much and our managers can pick up bargains then. Secondly, we should regard market drops as a time to buy into the market if we have any cash to add. If you want on my list of clients I have to call when the market is down a good 10%, please drop me an email.

I don't see a need to alter the style of investment or our portfolios at this point, since it seems to be working as expected. And I am pleased than my clients did not panic during this market volatility, and many took the opportunity to buy into the market on this dip. If you are worried, you can always call Jordan or me. Sometimes it helps to know why things are happening and what is expected. You can expect our normal answer though, that we should not panic and just stick to our long-term plan

One last thing, I will be on vacation from Feb 28 to Mar 16. Jordan will be available to assist you, so don't hesitate to call the office while I am gone.

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