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INVESTMENT THOUGHTS
FEBRUARY 2019

SENTIMENTAL JOURNEY

The Chicago Board Options Exchange Volatility Index (VIX) measures the market's expectations of the near term volatility of the S&P 500 index. The VIX reacts to both fear and greed as reflected by the option prices on underlying stocks. The measure constantly responds to new information made available to the market. New information or changes in market sentiment can precipitate buying or selling. Past volatility speaks to actual price movements whereas future volatility is what captures our interest once we have invested.

Most investors recognize the futility of sorting out daily stock price movements (short-term volatility) and consequently try to consider the character of their investment for the longer view. Short term turbulence at takeoff and landing is a bigger factor on a short commuter flight than on an international one. In any case, it is important to accept that volatility is a part of every portfolio of traded securities. Each asset considered for a portfolio will have a range of probable price outcomes. For instance a six month US Treasury bill has a very narrow distribution of likely price outcomes compared to Netflix. The overall price volatility of a portfolio is going to be the weighted sum of expected volatility ranges of each component holding. If this is measured every month versus over a three year time frame then average volatility will appear very different. Short term investors have to accept more volatility for their expected returns. The length of the measuring stick can affect perceived volatility. How long is the state of New Hampshire? If one measures from top border to bottom border it is about 190 miles but if you take a one mile measure and fit it into all the wiggles of the border line it will be much longer. One should mostly consider long term volatility of an asset in judging whether it is appropriate for one's portfolio. While the VIX index does not have predictive power we can observe in **Chart #1** that low volatility seems to last longer than high volatility for the S&P 500 index.

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Chart #1

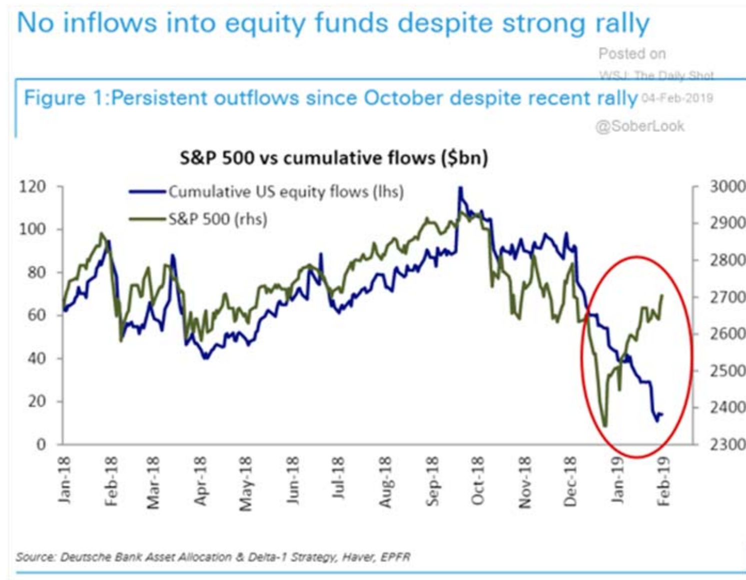
Investor sentiment reacts differently to downside volatility such that the VIX index will tend to move opposite stock prices. This makes common sense as generally the average investor's fear of loss outweighs the potential benefit of gains.

When we think of volatility we should not limit our view to the VIX Index. Investor emotions bring about changes in asset prices. An asset that typically has a moderate volatility history can be affected greatly by changes in investor sentiment. The market sentiment can be dominated by a certain consensus narrative that is suddenly changed, producing a massive swing in prices as has occurred in the last two months (**Chart #2** of S&P 500 below). In the last months of 2018 sentiment was palpably fearful of the Federal Reserve policy and a global economic slowdown but switched to euphoria on learning about good US economic news and that the Fed had backed off from an automatic interest raising schedule for 2019.

Chart #2

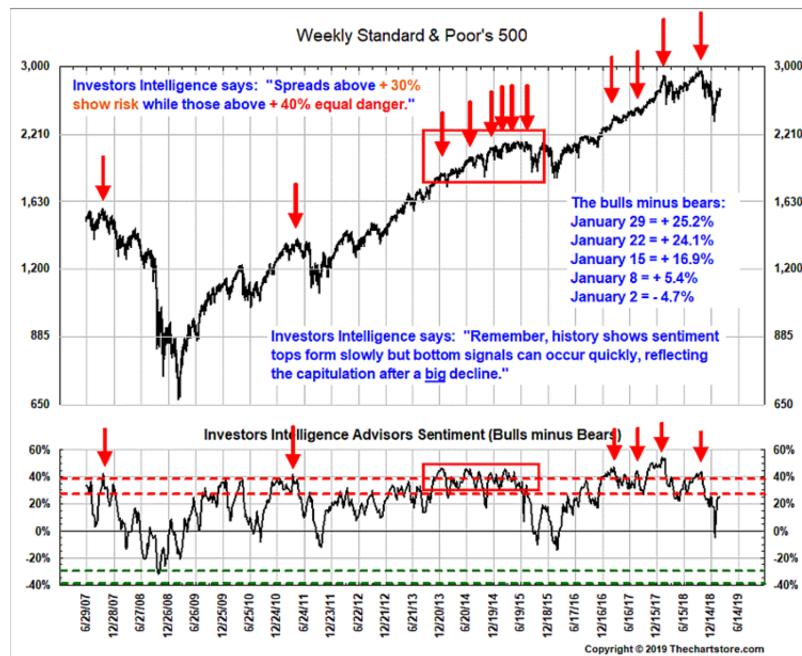
Investor sentiment (optimism or pessimism) can move to extremes creating what is often called overbought or oversold prices relative to recent trends and concepts of value. It is important to note that not all sentiment derives from the same investors. For example **Chart #3,** from Deutsche Bank, shows that despite a strong rally from the most recent bout of volatility retail investors were still selling in reaction to the first shock.

Chart #3



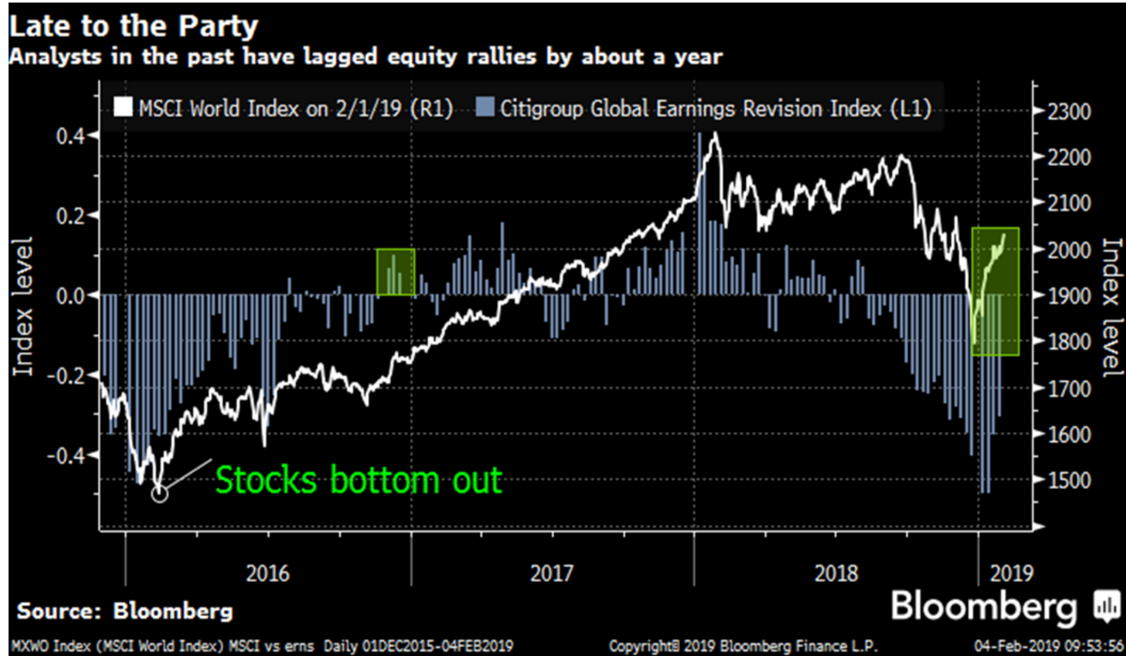
Professional investment managers express their sentiment divergences in **Chart #4** as shown by the percentage who claim to be bullish on the market compared to those expressing a bearish view. Market volatility tends to increase when the difference is broad and the manager's stock buys and sells create a net price change. It seems that market tops form slowly compared to when a bottom is reached and a quick change of sentiment ensues.

Chart #4



In addition there are the Wall Street stock analysts who follow individual stocks and opine on their values. They themselves can create volatility when they publish new opinions about a stock that is provocatively different from the consensus. However, as a group analysts are susceptible to groupthink as can be seen in **Chart #5.** Earnings were only revised upwards well after the market had rallied from a sell-off. The green highlighted area in the chart represents upward earnings revisions.

Chart #5



Investment Implications:

The sentiment(al) journey above gives some examples of how volatility can appear in a portfolio. We want to avoid negative volatility but not so much that we take away the chances for long term gain. Many excellent long term gains have had to endure some short negative periods. Instead, pay attention to short term negative volatility at extremes as a potential opportunity with the view that sentiment can change quickly. It is believed that black swans and black sheep (negative surprises) are somewhat rare but there will always be surprises to the long run expected returns of every asset. At these times try not to let emotion cause you to see the short run as extending permanently into the future, be it gain or loss.

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