November 2014

Volatility: Taming the Beast

Volatility sends many investors running for the hills. Often unexpected, volatility is a disturbance that can wreak havoc on an investor's returns but can also enhance them if handled properly. After months of record-low volatility, the uninvited guest crashed the party in October and took the markets on a roller-coaster ride. When the markets begin oscillating as they did last month, it can be nerve-wracking. However, volatility is a beast that can be tamed. Investors can take advantage of these uneasy times by staying focused on long term growth trends, having a sufficient amount of cash in their portfolio, and investing in holdings that minimize the risk profile of their portfolio.

Keeping the Big Picture in Mind

Staying the course in a volatile market requires focus on long-term macroeconomic data instead of day-to-day price swings. Precipitous short-term fluctuations are often driven by outside noise, not long-run economic trends. For example, in October, the Ebola scare was a major contributor to the market downswing. On October 15th, the same day the CDC announced that an Ebola-infected nurse came in contact with over 300 people, the Dow plummeted as much as 460 points before "rallying" to end down 173 points. The prospect of the deadly disease radiating across the US injected fear into the market and spurred the substantial drop. Yet in the long run, the panic was unwarranted and on October 22nd, the same day it was announced that the 43 people who were in contact with the US's first Ebola patient were cleared of the disease, the markets rallied and the VIX dropped 11%.

While Ebola should not be taken lightly, it is highly unlikely to cause an epidemic in the U.S., and it is unrelated to the underlying economic fundamentals that investors should emphasize. All throughout October, the macroeconomic numbers did not reflect an economy in distress.

- Unemployment decreased from 5.9% to 5.8%
- Economic activity in the manufacturing sector expanded in October for the 17th consecutive month
- Corporate profits in the domestic non-financial sector rose +11.9% to a new record high

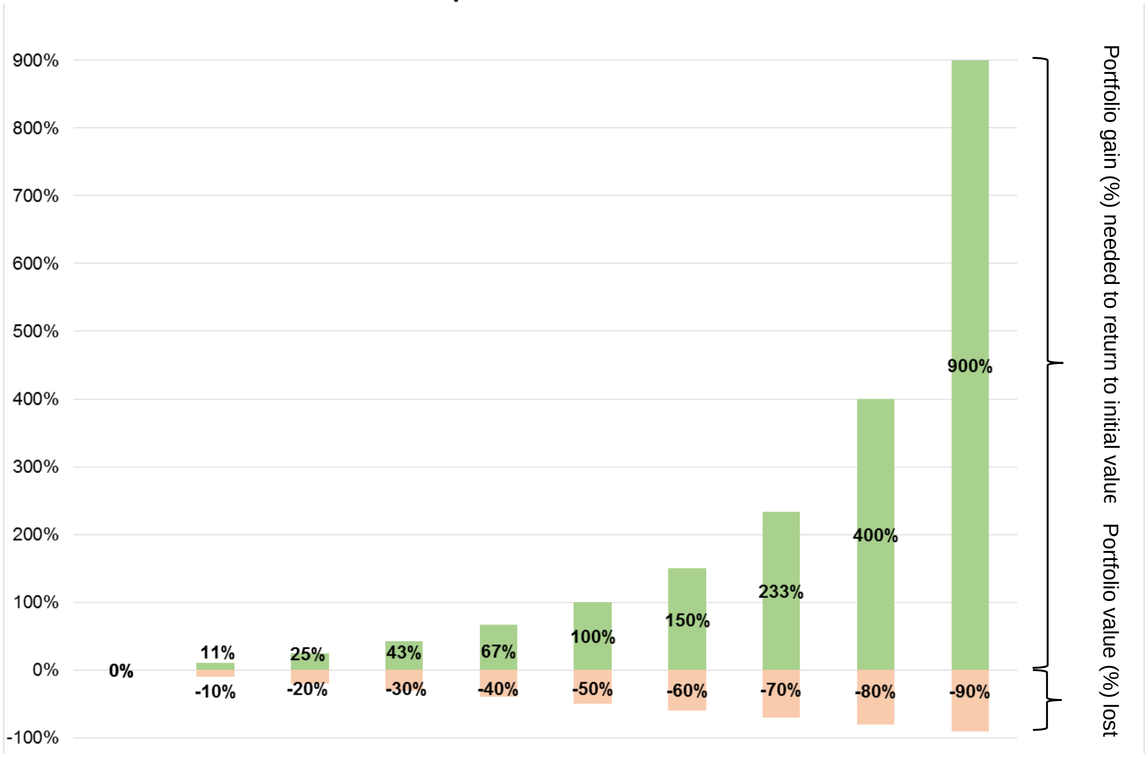
Markets are cyclical in nature and short-term corrections are necessary for long-run growth. While sudden downturns can hamper your short-term returns, maintaining conviction in the long-run economic data is imperative for enduring periods of volatility.

Why Cash is King

Another key to success during volatile periods is having extra cash on hand. In times of prosperity, the typical investor does not want to have a superfluous amount of cash in their portfolio, earning zero returns when it could be put to work in higher returning asset classes. Yet volatility is a prime example why having a cash position is vital for steady performance. During market downturns, cash can act as a buffer in your portfolio. In 2008, for instance, if your portfolio lost a third of its value (as many did), it would have had to earn a 50% return to recover to its pre-recession level. Cash mitigates losses because it maintains its value during downturns. In the example above, if 10% of your portfolio was in cash, you would only need a 43% return to restore the initial value lost.

Besides providing downside protection for your portfolio, cash also offers flexibility for investing when the markets are down. The golden rule of investing is buying low and selling high. The problem is the timing. When markets do enter correction territory as they did in October, investors often do not have enough cash on hand to take advantage of the low prices. To buy at these low prices without cash requires investors to sell other positions, often at a loss. Having an ample cash position allows investors to enter undervalued asset classes at the correct time.

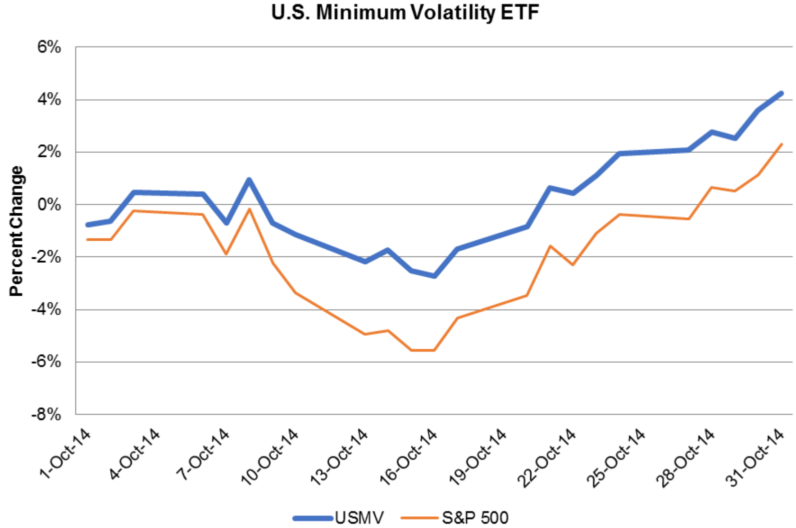
Gain Required to Restore Value Lost



Reducing Risk

A third component of reducing volatility in your portfolio is utilizing investment vehicles that lower the risk profile of your portfolio. Minimum volatility ETFs (Exchange Traded Funds) are structured to offer downside protection to your portfolio. They track indices that are less sensitive to market fluctuations and are less dependent on economic growth. Our two minimum volatility ETFs performed exceptionally well during October's wild ride. iShares MSCI USA Minimum Volatility ETF (USMV) was up +4.25% for the month and iShares MSCI EAFE Minimum Volatility (EFAV) was up +2.59%, while the S&P 500 was only up +2.38% and the MSCI EAFE index was down -1.50%.

U.S. Minimum Volatility ETF



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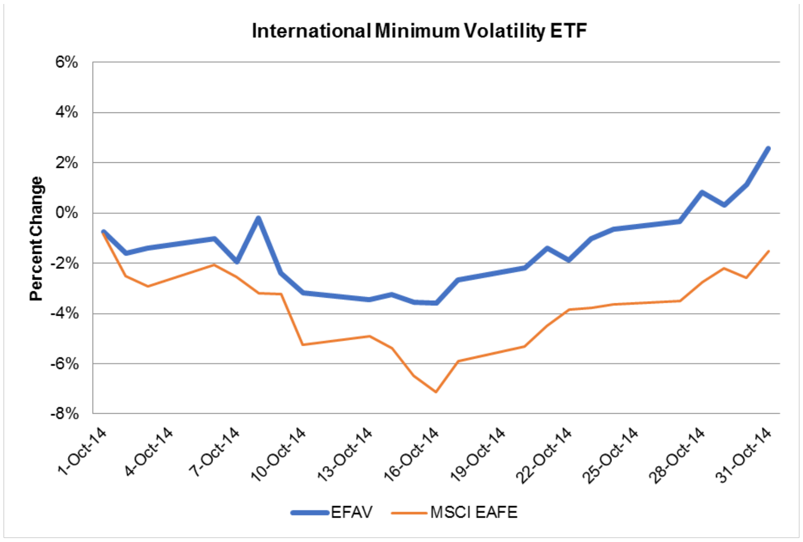

End of the Year Predictions

On the heels of October's dip, November has brought out a sense of calm in the markets. During the week of November 10th to November 14th the S&P 500 never made more than a 12 point move. The headlines that were creating unrest in October have faded away. Global health officials are on the path to containing Ebola, the midterm elections created a new Senate majority for the Republicans, and the Fed ended its latest round of QE. Despite slowing global demand, the macro data is still unwavering in support of a growing US economy:

- GDP grew at 3.9% in Q3
- The Consumer Confidence Index reached 94.5 in October
- US retail sales in October rose 0.3% to $444.49 billion
- The S&P 500 closed Thursday, November 20th at 2052, its 43rd record high close this year

The holiday season should continue the positive growth trend as lower gasoline prices will leave some extra cash in consumers' pockets. Analysts have predicted that the tumble in gas prices will save consumers $52 billion, which should raise holiday sales by over 6%. U.S. consumers account for almost 70% of domestic economic activity, so a strong December could push the S&P 500 to 2100 by the end of 2014. Even if the markets do slip slightly in December, the S&P 500 would still be on track to end the year up over +10%, which would be the third year in a row with a double digit gain.

Despite strong economic headwinds in the U.S., there are tremors in the global economy. Japan has slid into a recessionary environment after its GDP fell -1.6% in Q3, following a -7.3% contraction in Q2. Meanwhile, growth in Europe has been anemic as the Eurozone is on the verge of deflation (Greece, Spain, Italy, Slovenia, and Slovakia all posted negative CPI's in October). Both the Bank of Japan and the European Central Bank have announced that they will be ramping up their own quantitative easing policies in response to the alarming state of their respective economies. Yet it remains unseen if the easy money will boost activity in these regions or if it will send more investors seeking a safe haven in American equities and therefore driving up the value of the dollar. The rate U.S. equities are outperforming European equities is at a 40 year high (14% annualized growth vs. 6% contraction), and it should only increase in Q4.

In addition to Europe and Japan, the emerging giant, China, is also in a troubled state. Manufacturing in the world's second largest economy fell to a six month low in November and the country's annual growth slowed to 7.3% in Q3. The slowdown abroad could heighten volatility in the markets. If this scenario does arise, it is important that your portfolio is positioned for success. By focusing on the long-run fundamentals, having extra cash available, and maintaining low risk holdings, volatility will no longer be a foe.

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