MARKET INSIGHT

Figures never lie, do they?

Volatility in Financial markets - lower is not always safer!

With this bull market now approaching its 10th year of straight gains, one cannot deny it's been a great ride for investors and fund managers. Investment return over the timescale has been slow but sure and remarkably consistent. The champagne industry may attest to how steady things have been. However, has the market become complacent when it comes to evaluating risk? For the last 10 years things have only ever gone up, after all.

Bear with us for a quick bit of theory. More often than not the words "risk" and "volatility" go hand in hand when discussing markets. "Volatility" is simply the statistical measure of the difference in returns that one might get from a particular investment.

Enter the "VIX index", or more fondly known as the "Fear Gauge". This index is a tool that simply measures the price that investors are willing to pay to insure their investment portfolios from a selloff in the market. Simply put, the more that fear investors have about a selloff, the more they are willing to pay to protect themselves, and the VIX level rises.

Every investment vehicle (that's an Investment fund in the TAM context) takes its quoted level of risk from the specific risk of the direct investment, and the broader market risk represented by a variant of the VIX index. When global markets are in slow but sure rally mode, the VIX deceases and thus the measure of a fund's market risk also decreases. The slower and steadier the rise (or indeed a fall, should it happen), the lower the measure of volatility will fall.

Here we believe there is a fundamental disconnect with reality at present. Historically speaking (20 years plus), the VIX index has always moved up and down, accurately representing market movements and aberrations. Everything from macro shocks in politics, military conflict, economic uncertainty and market crashes have seen investors seek to protect themselves. Since 2009, the VIX index has been stuck in a downward spiral as complacency in the upward trend of markets has seen this "fear index" fall to record lows. We are not talking record lows for a couple of months, but consistent lows for multiple years.

If Robert Whaley (the father of the VIX index) caught a glimpse of his beloved VIX index from 2008 to 2017 and its persistent low levels, it might have led him to the conclusion that the human race had solved the very meaning of life!

All one has to do is pick up a paper to know the last 10 years have seen North Korean nukes, Russian invasions, military coups, massive political populism, famine, terrorism and the largest financial experiment the world has even seen (QE). None of this has fully reflected through into volatility, so why not? Some simple explanations may be in the forerunner piece by TAM entitled, "Nowhere to Hide". With the VIX not moving, this tells us that investors are simply not interested in trying to protect their portfolios, and are instead more interested in leaving capital at work in the equity markets.

In our opinion, the statistics are lying to us!

Below is a 9 year chart of the VIX index. In 2008's financial crash, investors rushed to insure their portfolio, pushing the VIX to peak at 74, yet since mid-2011 the VIX has been through a period of record lows.

Are we therefore in an era of ill-advised complacency, or is there a paradigm shift in the way we review risk? Unfortunately and unavoidably, because of this long term disconnect, we think investments are more, not less risky. The statistics will tell you otherwise and for those that think the status quo on volatility over the past few years is the new norm - good luck with that! Let's go back to plain common sense for a second. A larger portfolio of diversified, global investments will spread out an investor's overall level of risk over more strategies and thus is more likely to add protection in a selloff. Concentrating capital into fewer investments, irrespective of anything else, also concentrates the risk and any pick up in the VIX is likely to sharply affect these portfolios.

Some of our more astute connections have spotted that the more concentrated portfolios have offered less risk (measured by Volatility). That has been the case in this environment and the very recent past. In short, this is where statistics such as the VIX can mislead. In actual fact, the low risk score is more the product of some excellent investment selection rather than the reality that risk is lower – because it most certainly is not! Investment selection is masking underlying portfolio volatility/risk.

Another painfully obvious observation is that with markets at all-time highs, the downside from here could dwarf the upside. Should a proper old fashioned 20%+ selloff hit capital markets, the VIX is going to spike, and spike sharply. We think this is going to have more of a harsh impact on the undiversified portfolios.

This, to us, is where established measures of risk are starting to mask the core pillar of portfolio construction in capital markets - Diversification.

As investors, we have been conditioned to consider traditional measures for levels of risk and little else. The point we raise is that when this calculation starts to show signs of dysfunctional behaviour, we need to adjust how much we allow that measure to dictate how we invest.

Lower volatility and therefore lower perceived risk, just means that when volatility picks up, the impact could be more powerful. To draw an analogy - if you live in an earthquake zone and constantly get tremors then they become the norm, you live with it. If you do not live in such a zone and suddenly experience a tremor, it could impact you significantly.

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