SURVIVING MARKET VOLATILITY: INVESTING IN EXTRAORDINARY TIMES

By Michael Kassen

At present, volatility as measured by standard deviation of monthly returns for the S&P 500 is only a hair above average, and not as high as during the bear market of the mid-1970s or the crash of 1987.

According to an old saying, "an economic downturn becomes a recession when your neighbor loses his job—and a depression when you lose your job."

The same concept holds true for market volatility. When the markets are going up, volatility can be your friend. But when your holdings plunge, good old volatility becomes the enemy.

These days, a lot of investors are moaning about volatility, and for good reason—single-day swings in the stock market are at their highest level in decades.

Has volatility ever been worse?

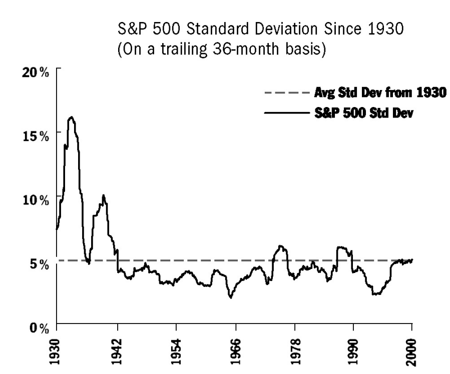
That depends on how you measure it. Volatility is said to be high when prices or yields change dramatically in a short period of time. But what is the proper time period to measure?

In the last few years, intraday volatility has indeed gone up. Since 1996, the Standard & Poor's 500 has experienced daily price swings of 1% or greater more than 31% of the time, well above the rate of 21% from 1990 through 1995. Last year, the percentage of 1%-or-more price swings hit a whopping 41%. The last time this level of volatility was seen was in 1973, 1974 and 1975 and again in 1982 and 1987.

However, if you look at volatility through another prism—the standard deviation (variability) of S&P 500 monthly returns over a 36-month period—the picture changes somewhat (Figure 1). The standard deviation of S&P 500 returns peaked way back in 1933 at more than 16%. The next high, of 10%, was not seen until 1940, and nothing like it has occurred since—not even in the year 2000.

At present, the standard deviation of the S&P 500—about 5.03%—rests only a hair above average. Recent standard deviations are not as high as they were for the bear market in the mid-1970s, or after the crash of 1987.

FIGURE 1. VOLATILITY: THE LONG-TERM PERSPECTIVE



Source: Neuberger Berman; Standard & Poors

In sum, people's perception of market volatility is subjective. And while the daily ups and downs are frightening, over the long term they amount to just so much market "noise." In fact, judging by the low volatility of monthly returns, one could say that volatility is not an especially bad problem today. What people are really complaining about is price *drops*, not volatility.

Michael Kassen is chief investment officer at Neuberger Berman, an investment advisory firm based in New York.

WHAT'S CAUSING THE VOLATILITY?

There is no sure-fire protection against volatility's downside. But understanding what causes it can help investors separate the market noise from the genuine article, and there are some basic tools that can help limit volatility's toll on a portfolio.

While there is no strong agreement on what causes volatility to fluctuate or even what causes it in the first place, we can identify some likely causes behind today's market volatility. Among them:

- *Sea change that has taken place in the U.S. investor base:* From 1982 through 2000 the percentage of U.S. households investing in equities increased from 10% to more than 50%. Perhaps not coincidentally, the Dow Jones industrial average rose from 800 to more than 10,000—the longest bull market since the U.S. stock market's inception.
- *Technology's effect on trading:* For the first time in history, investors—anywhere, anytime—can execute a trade at the push of a button or the click of a mouse.
- *Increasing performance pressure on mutual fund portfolio managers:* This puts increased pressure on money managers to pull the trigger on stocks that threaten their performance.
- *Excess leverage in the market:* By the end of March 2000, margin debt had ballooned to $278 billion, an all-time record that peaked at the same moment of the collapse of the high-flying technology sector. Borrowing on margin can force investors to sell in a falling market, which exacerbates selling in a snowball effect.
- *Starkly conflicting views about the market's direction, and sector rotation:* Much of today's volatility is simply a result of the marketplace reacting to fundamental overvaluations. With technology and telecommunications sectors priced at record-high multiples, and value sectors at rock-bottom prices, these sectors were poised for a dramatic turnaround.
- *New industries:* A growing amount of the S&P's market volatility in the last decade has been in the technology sector. Since early-stage industries—like many technology sub-sectors—have no historical record to guide the market's projections, estimates on the timing, magnitude, and riskiness of these cash flows can fluctuate significantly, causing big and sudden changes in stock prices. In this sense, much of the volatility we've seen is the result of the markets' effort to come to grips with the fundamental growth and profitability characteristics of new industries.

TOOLS TO TAME VOLATILITY

Good or bad, volatility is here to stay. In fact, when financial wizards have tried to eliminate it from their portfolios completely, disaster has struck. Take the spectacular failure of portfolio insurance in the 1987 market crash. The product was supposed to guarantee investors that if stock prices fell, they would have synthetic put protection, or a comfortable floor, on the downside. But when stock prices fell sharply in October 1987, the portfolio insurance strategy called for stock sales, worsening the crash.

Ironically, much simpler tools—the tried and true methods—are available to limit volatility in individual portfolios.

Diversification through plain old asset allocation remains one of the best tools to avoid the risks inherent in market volatility. Since the major asset classes—stocks, bonds, and cash—tend to have low correlation with each other, when one asset class is not performing well, another may do better.

Various equity groups also have different levels of volatility at any point in time. Until recently, for example, foreign stocks tended to be much more volatile than U.S. stocks. That trend has been reversed lately. Last year, the small-cap value area, which historically has been relatively volatile, was not nearly as volatile as large-cap growth.

Many professional money managers have reacted to growing volatility by spreading their portfolios over a broader number of stocks or bonds that do not correlate with one another. Some recent research indicates that a portfolio needs at least 50 stocks to eliminate 90% of its "specific risk"—in other words, the risk that the portfolio could go down while the overall market went up.

No matter how diversified a portfolio, fundamental research on individual stocks may be more important in today's volatile markets than ever before. When a well-capitalized, broadly followed stock can drop 50% in one day, as did Apple Computer last year, investors must know their investments inside out, and watch them like hawks. Changes in market sentiment can overtake a stock practically overnight.

BACK TO BASICS

In short, the tools to manage volatility are basically simple ones: diversification, thoughtful portfolio construction, and fundamental research.

As always, recent events are not a likely predictor of what the next few months or years may provide. Perhaps volatility will diminish over the next few years. Or perhaps it will become more extreme.

But one thing is certain: it will not disappear, so investors must learn to live with it. ✦