the tortoise & the hare

Staying the course

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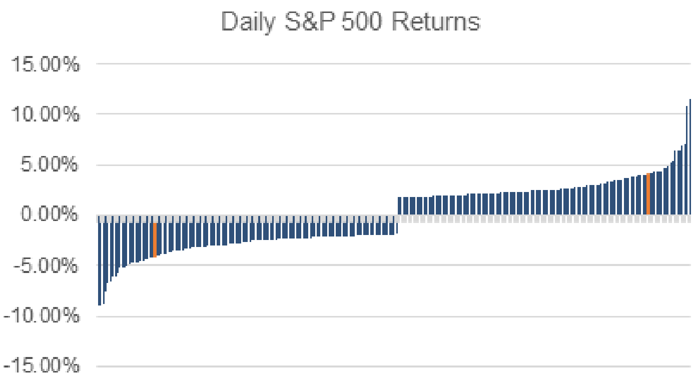
The losses observed in equity markets in early February shocked many investors. Understandably, many were worried about further bad news to come. Within the space of only two weeks, the S&P 500 index dropped from its record level of 2873 to 2581, losing more than 10% of its value. Media headlines focused on the single day declines of more than 4% and a spike in volatility (see the blue line in the chart below).

I found the times leading up to February much more newsworthy. Looking at the green line, it looks almost straight. In 2017 the S&P 500 had only one month of negative return!

The VIX, the most well-known indicator of equity market volatility, spent most of the year at historically low levels, before tripling within a week. The extraordinarily calm times ended with an extraordinary bang. I believe that, if investors had not been lulled into a false sense of security, that equity markets will never provide for very long, the reaction would not have been as dramatic.

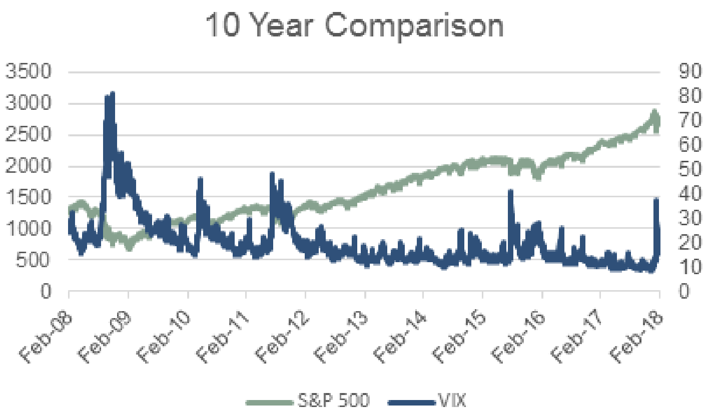
We only need to look at the past 10 years to remind ourselves of what real volatility expectations should look like.



Here we see the best and worst 5% of daily S&P returns, with the orange lines indicating the magnitude of return we saw on February 5th.

Staying the course

The fact that the orange lines are even visible on the chart can be interpreted as February 5th being a rare occurrence. That said, one is also reminded that the last 10 years provided investors with many swings of similar or even greater magnitude.



If we attempt to put last year and the recent February market movements into a long-term context, we first see that the green line still looks relatively straight. Since the Global Financial Crisis nine years ago, it seems like the only direction for US equities is up. However, every party must end at some stage and this one is no different. Even though these gains have been fuelled by robust GDP growth, unprecedented liquidity, global dominance of some US tech companies and recently cut taxes, valuations do not lie about future expected returns. The current level of US Equity CAPE (Cyclically Adjusted Price to Earnings) is in the 97th percentile of its long-term history and US small cap is the most expensive it has ever been. Recent market events have served as a warning to investors, although February still ended up being a positive month for the S&P Index. This means the party will continue, maybe for a few more months or even years.

Should the US economic or profitability backdrop seriously deteriorate relative to the rest of the world, our reduced exposure to the US would support portfolio performance. Similarly, if there is a global recession at any time in the next few years, our allocations into Total Return solutions are in place to provide support to performance.

As you can also see in the previous chart, periods of high volatility come hand in hand with equity investing. We are able to identify four other volatility spikes in only the last 10 years, with the earliest one reflecting the Global Financial Crisis. By showing you this I intend to put things into perspective and hopefully enable you to remain composed next time markets drop. Of course, that is easier said than done, particularly since few readers have followed the markets as closely as I have for the last twenty years.

This brings me to my final and perhaps most important point. Maybe one of the reasons why you have chosen to entrust MASECO with your wealth is that we can provide the rational thinking that you may struggle with in periods of market turbulence. I can assure all clients that this is absolutely the case. Since I joined MASECO, at no point have I questioned our investment philosophy or approach. We firmly believe that markets are largely efficient and that fund costs and tax charges can be a serious detriment to returns. Always staying rational is critical and systematically pursuing robust academic evidence, to us, seems more reliable than jumping onto the latest asset class or star manager band wagon. Particularly since good recent performance is often portrayed as though it will continue forever.