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Does Stock Market Volatility Make You Nervous?

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Snapshot

- On November 28, the three major U.S. stock market indexes each gained at least 2.3% in a single day.
- As of December 4 this year, the S&P 500 Index was on track for its worst fourth-quarter start since 2008.
- We believe that some of the most useful tools an investor can have during big market moves (up or down) include a level head and a diversified portfolio.

The recent increase in market volatility and decline in share prices delivered an unwelcome turkey over the short Thanksgiving week. It not only surprised many investors but also brought back some of the fear felt during the 2008 market meltdown. Most U.S. equity markets had given back all of their year-to-date gains by Thanksgiving this year, and the S&P 500 Index was on track for its worst fourth-quarter start in a decade.

The other side of volatility was showcased just after Thanksgiving when the S&P 500 Index jumped 2.3% higher on November 28—returning in a single day more than double its year-to-date gain as of the prior close. For investors, volatility's carving knife can cut both ways: Upside volatility may seem like the benign (or even favorable) side of instability as it delivers strong returns. But it can be harmful to those who recently lost their appetite for investing on the downside and exited the markets. In other words, selling stocks when the markets fall means missing out on potential gains once prices swing higher.

It's Been a Bumpy Ride

There is no doubt that we've seen bumps in the road recently. In 20 out of the 46 trading days between October 1 and December 4, the S&P 500 Index ended the day up or down by more than 1%—nine of which were negative and 11 positive. Such a move occurred about once every two days during this period, while between January 1 and October 1, we saw similar moves a little less than once every five days.

During seven out of the same 46 days, the Index was up or down by more than 2%, while over the prior nine months, the Index had only eight such moves. The result of the two-month roller coaster ride has been an almost 8% drop in the S&P 500 Index.

The VIX: A Thermometer for Volatility

While it can be measured in several ways, one common measurement of investment volatility is the CBOE Volatility Index (VIX). The VIX helps investors gauge market volatility by estimating anticipated annualized price movements in the S&P 500 Index over the next 30 days, as quantified from options-based market information; it is measured in real time by the Chicago Board Options Exchange.

Although informally referred to as the “fear index,” high VIX readings are not automatically bearish for stocks. The VIX identifies expected volatility to both the upside and downside.

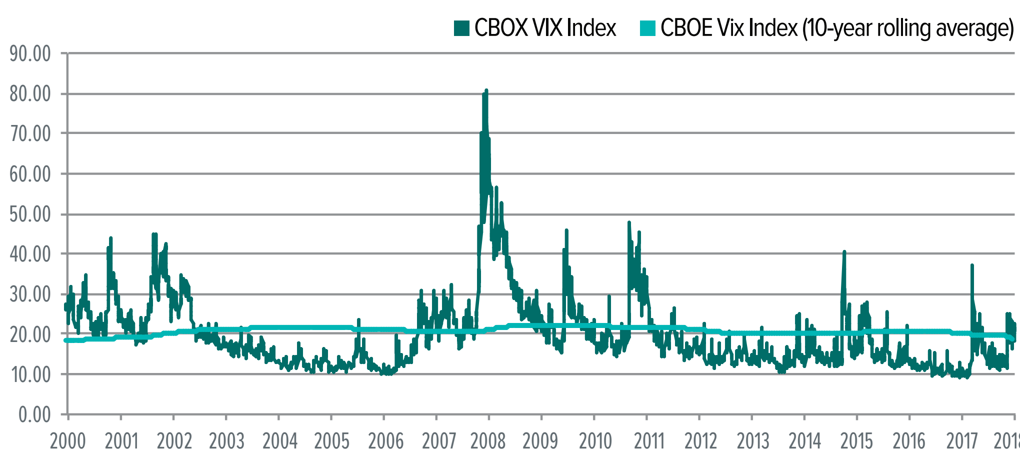
Above-average VIX prices indicate extended risk that the market will move significantly, either downward or upward. The most extreme VIX levels happen when investors believe large moves in either direction are likely.

What is Normal?

At a current level around 20 toward the end of November, we are a significant distance away from historic highs in the volatility index. In 2008, the VIX reached an intraday high of 89.5 during the early days of the global financial crisis. In February this year, a one-day 100% surge in the VIX came after the Dow Jones recorded its worst single-day point decline in history.

While it’s human nature to feel discomforted by the recent acceleration in volatility, it’s also practical to keep in mind that volatility is normal. Volatility has been higher in the past and will likely increase from its current level at some point in the future (Exhibit 1). It’s an expected, if unpredictable, part of investing and is as dynamic as the market itself. Nobody can say with certainty where either the market or volatility will go from this point.

Exhibit 1: Volatility is Normal



Source: Bloomberg, SEI

Always Another Crisis

This most recent period of volatility has been blamed on everything from rising short-term interest rates to sluggish global growth and investors seeking resolution on trade relations with China. Geopolitical tensions and instabilities have also posed worries for the market this year. The next perceived crises may be something unexpected.

Some of these events will bring swift and volatile market reactions, while others will fade into obscurity. But there will always be another crisis lurking on the horizon.

Our View

It's not possible to foresee every crisis or every developing bit of positive economic news, nor is it possible to predict how markets will react to these events. Investors do, however, have a level of control over their investment destiny, despite short-term market movements. By setting goals and properly aligning resources with those goals, market events become little more than noise.

SEI believes that the best approach to investing is one that focuses on diversified portfolios designed to provide consistent returns over a specific time horizon in accordance with an investor's risk tolerance. Market environments like today's serve to remind us how important it is to have a disciplined and well-designed approach. While it's reasonable to monitor day-to-day events, it's important to keep in mind that daily, weekly, monthly, even quarterly market movements are often little more than noise for a portfolio that has a time horizon of more than a few years.

In short, SEI believes it is essential for long-term investors to be patient when faced with panic-inducing headlines. If investment time horizons are measured in years, it does no good to worry about day-to-day reports of doom and gloom. As today's global crises run their course, we believe an investor's best defenses include a level head and a diversified portfolio.

Index Definitions

S&P 500 Index: The S&P 500 Index is an unmanaged, market-weighted index that consists of 500 of the largest publicly traded U.S. companies and is considered representative of the broad U.S. stock

VIX Index: The VIX, or Chicago Board Options Exchange Volatility Index, uses option prices on the S&P 500 to estimate the implied volatility of the S&P 500 Index over the next 30 days. Options are derivative contracts that give a buyer the right (and impose upon the seller an obligation, if called upon by the buyer) to buy or sell an underlying security at a specified price, usually for a specified period. A higher number indicates greater volatility and an increase in the VIX is often associated with higher risk aversion among investors.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

There are risks involved with investing, including loss of principal. Diversification may not protect against market risk.

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