October 1, 2014

Market Volatility and Investment Risk

The S&P 500 has retreated from its recent high of 2,011 on September 18, 2014, to 1,972 on September 30. Market valuations have increased over the past six years as U.S. businesses have recovered from the Great Recession. These stock price increases have been based on positive corporate fundamentals, which include cash flow, revenue, and earnings growth. The Federal Reserve (Fed) policy of low interest rates also has influenced investor behavior and optimism.

It appears that a growing number of investors are becoming more concerned about the future economic and corporate outlook. An economic recovery that lasts six years is longer than the typical economic cycle. Although U.S. GDP growth is expected to remain positive, there is some concern that economies of China and Europe may be slowing. Should such slowing occur, aggregate demand for U.S. exports might decrease, causing multinational corporations to reduce their forecasts. A strong dollar also causes exported products to become more expensive, possibly reducing demand for U.S. exports.

Significantly, it is unknown what the future Fed policy will be regarding interest rates. Low interest rates will not last forever. Many investment professionals have been stymied by the Fed policy of the past few years. Incorrectly guessing the Fed's interest rate decisions has been costly for many investors.

Geo-political concerns also impact portfolio decisions. Investors are interested in current events such as the Russian "stealth" invasion of eastern Ukraine, the fundamentalist Muslim's ISIS battle successes in the Middle East, the global threat of the Ebola outbreak from West Africa, and China's growing naval presence in the western Pacific and Indian Oceans.

Stock investing is about owning businesses. Business owners typically own their companies for many years. Equity investing is not about trading. It is, as Warren Buffett has articulated, about owning a business. Over time, owning strong, well-managed businesses in stable industries with good cash flow, sustained sales and earnings growth, and strong balance sheets creates great wealth.

Investment risk is reduced when one owns a diversified portfolio of strong businesses with excellent characteristics and competitive advantages in sustainable industries. Great companies that pay dividends have the financial characteristics allowing for an increasing dividend stream to offset monetary inflation over time. Investment risk is not a primary concern in owning these businesses.

If publicly-traded businesses trade at a premium to their underlying fundamentals, the stock may become incorrectly priced. When this occurs, volatility risk becomes an issue. Eventually, prices will decline to a level which supports the underlying value of the business. Infrequently, companies may be priced at a substantial discount to that intrinsic value. (What would the business sell for if it were a private company?)

Volatility risk occurs when valuations become extended. Occasionally, it is in a specific company or industry. At times, the entire stock market trades at an overvalued level. By some measures, the broad market is currently trading at a premium. When this occurs, there is likelihood that the market will re-price itself. Stocks have a tendency to regress to the historical mean.

The challenging task for a portfolio manager is to properly allocate capital and manage risk. It is unknowable when a market decline might occur. To reduce stock portfolio volatility a portion of the portfolio should be allocated to bond or short term debt securities. An allocation with fewer equities can reduce volatility risk, but not eliminate it. Each investor's portfolio is constructed with these factors in mind.

Market volatility is part of investing. It can be vicious at times. An investor's greatest challenge is finding the balance between making money in a bull market, and preserving purchasing power and capital in a bear market. Emotions play an important part of making such allocation decisions. Managing emotions is, at times, more difficult than managing portfolios.

A commitment to owning great businesses is the best protection and prescription for being a successful investor.

- Roger L. Johnson