



August 2015

Market Update – Market Volatility

Market volatility is finally back. It has been over two years since we had the “taper tantrum” that brought about a 2% sell-off. We have not seen a 10% correction in the market in over four years. It finally shows up and some commentators are shocked to see it happening. We are not. When the market is trading at 10,000, a 500 point move is a bigger deal than a market that is trading at 16,000.

There are several reasons why we are not overly concerned with the market movements in the past week. First, it is within the range of our return expectations. Normally we are looking at volatility around 20%, this is a historical average. What does make the last week’s movements a bit unusual is that volatility increased quite rapidly, from 13% to 26% in the span of a week. We attribute this to our second point.

Second, with record funds going into index funds in 2014, there are much less “active” participants in the market. As we look at the market activity, most of the largest holdings in the indexes are getting hit the hardest. There are fewer market makers, so at a time with lower market participants, they have a higher ability to impact stock prices.

Third, we are seeing a global repricing of securities. In our opinion this is more based on commodity prices and currencies. The dollar is strengthening against foreign currencies. We do not actively try to predict currency cycles as they are near impossible to do in the long run, however, this will help foreign countries compete in a global economy by making their goods and services cheaper. This will also help the US consumer by keeping import prices down. Short run changes can have large impacts on equity prices. We do not like to see them. In the longer run, however, these price changes work themselves out, to the advantage of equity holders. This is what we are waiting for.

As long term investors, when we see dramatic market movements, we need to be academically honest with ourselves if anything has materially changed from our expectations, aside from the obvious price change. As many of you already know from recent meetings, our expectations for US stocks is quite muted over the next 3-5 years. This does not mean we will see a slow, gradual climb in US stocks, it means that our expected value of US stocks 3-5 years out will grow slowly, but in the meantime investors can push the market up and down during the cycle. We still expect to see roughly 20% volatility during the process.

In international markets, we do expect to see higher expected returns. Today’s currency actions enforce that thinking; it does not detract from it. As US investors, however, we should see increased volatility with the added currency exposure. We have been asked if we should hedge the currency risk that we take on. Some of our managers have taken small hedge positions on; however, we see that more as a risk mitigation strategy, not a return maximization strategy, so we would not do it as an active strategy. In our opinion it lowers overall return, with little benefit.

The last week’s market activity is never fun to go through, but it is the price that we pay in order get long term market rates of return. Warren Buffet once said that in times of crisis, stocks return to their rightful owners. We are happy to be those owners as the market returns.

As always, don’t hesitate to call us with questions or comments.

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