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• One Man's Opinions – Summer 2012

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August 1st marks the 50th anniversary of my entry into the investment business with August 15 marking the 37th anniversary for McAllister Financial Planning. I look back at my career and thank my Maker for the great opportunities that have come my way. I am also grateful to my clients, past and present, my colleagues, and my readers, who have kept me on my toes. I have a fascinating and highly rewarding profession, psychologically and emotionally, as well as financially. I am very blessed indeed.

There have been some challenging times, such as 1973-74, 2001-02, and 2008-09, but to have survived and prospered as I have is a blessing second only to my wonderful and growing family and my good health. Thanks to all my clients and friends who made it possible.

And thanks too, to my audiences on the cruise ships, who have made my work even more satisfying and such great fun these past eighteen years. In September I will take my 65th cruise. I have now visited 143 countries! What a wonderful life!

Our topic this quarter is volatility. Most investors and many stock market observers and commentators complain about it. The financial media often remind us that we have more volatility "*now*" or "*these days*." The implication is that volatility is bad and it is getting worse! But the fact is that stocks and the stock market *are* volatile. They always have been and surely always will be. It is the nature of the markets to move up and down in varying degrees of volume and breadth. For us human beings, that can be terrifying. But it is not abnormal and it is not necessarily bad. I will attempt here to at least ameliorate some of my readers' fears.

I never hear or read complaints about volatility on the *upside.* Strong up markets are perceived as "good" and they make us feel that God is in His heaven and all is right with the world! Since such wonderful days can be, and most often are, of limited duration, the complaints have to do with the down days, weeks, months, or years. The advent of 24/7 news on cable TV and the internet has made all of us increasingly aware of the "down" aspects of the stock markets.

But what we need to keep in mind is the enormous growth in stock trading worldwide since World War II, and the enormous increases in trading volume here in the United States. I well recall the day in August 1962, as a brand new trainee with Merrill Lynch chosen to offer the firm's radio market reports in Indianapolis, when I reported that the volume on the New York Stock Exchange for the *day* had been 1.8 million shares! These days we trade a thousand times as much on the NYSE; some individual stocks trade more than that all by themselves! So there is a lot more coverage, a lot more diverse base of stock owners, and a lot more attention being paid to the stock market and, naturally enough, to its innate volatility.

In just the first full week of June of this year, the stock market was up all five days on heavy volume. It recovered approximately 30% of its decline of the previous two months, which in turn had completely reversed the 10-12% gains in stock prices during the 2012 first quarter. That week represented a welcome turnaround, but it serves to demonstrate the complete randomness of the stock market. We simply cannot know when the market is going to retreat, rise, or to just to tread water for awhile. To make things even more frustrating, individual stock prices can, and many do, trade completely out of sync with the overall market.

If we are going to invest in stocks, we must accept the fact that they are completely random in their movements, and that such movements are going to sometimes be quite volatile. For starters let's examine just what volatility is. It is neither good nor bad, it just IS! Volatility applies to both up and down movements.

In order to measure volatility we first determine a "standard deviation (SD)." You may have covered this in college, and perhaps I did too, long ago. So just what is this marvelous measuring stick? SD measures how much something deviates from its expected average. You can use SD to measure historical deviation of individual stocks, sectors, indices, or the market as a whole. For that matter we could also measure the SD of hot humid summer days in Indianapolis, or rainy days in Florida. A low SD number means results did not vary much from average. A higher SD means there was more variability.

From 1926 through the end of 2010, the Standard and Poor's 500 Stock Index' annual average deviation 19.2%, based on monthly returns. (Deviation can be calculated using yearly or daily data, but the investment industry normally uses monthly data to determine SD.) This result does, of course, include the bear market years of the Great Depression. Were we to exclude those years, the SD since 1926 would be only 12.9%.

One must remember that standard deviation is always a *backward* look at known numbers. It shows how stocks have behaved in the *past*. It cannot and does not predict anything about future volatility. However any historic look at the stock markets suggests that we certainly CAN expect it to deviate!

A standard deviation of 0 means that, historically, returns have not deviated at all. If we discard inflation, cash shows zero SD. A modestly positive number means some deviation; a higher number means higher deviation**. But we don't need historical deviation numbers to know that stocks have been volatile for as long as they have been traded.** In certain years market volatility has been vastly above the norm, in other years far below. In some years it has been both. An average includes all prior years being measured.

Now let me surprise you. The most volatile year on record since 1926 was 1932, which included the bottom of the very worst market in U.S. history. The SD was 65.24%, with monthly returns varying hugely. So, stocks fell hugely in that year, right? Wrong! In 1932 stocks fell just 8.11%, not good, but not a disaster, either. The next most volatile year followed. In 1933 the SD was 53.8%. Wow, that must have been awful for stocks! Wrong again, stocks ended the year *up* 54.4%! More recently, in both 2008 and 2009 we had above average volatility. Which of the two years was worse? 2008 of course! Wrong again! In 2008, a terrible year in the market, SD was 20.1%. In 2009 it was 21.3%, and the markets were *up* 26.5% for the entire year, but had recovered 67.8% from the March 9 bottom of that bear market. In 2010 things quieted down, and SD was 18.4% with the market up 15.1%.
Volatility in and of itself, is no indicator whatsoever of market direction or strength. We can have high volatility with and up markets and down markets with low volatility. We cannot use volatility to predict anything!

So why does this attribute of the market upset people so much? I think it has to do with our amygdala, or "lizard brains," which I discussed in great detail in One Man's Opinions spring edition three months ago. Anything that disturbs or threatens us triggers an instant reaction from this always alert, survive-or-die, portion of our brains. Lower animal forms all the way down to lizards have such a mechanism (In fact, in lower forms, that is all the brain they have!)

Just as unusual or extreme physical motion upset our bodies' equilibrium, it seems to me that unusual or extreme movements of the market also upset and alert our amygdala, causing instant fear of loss or damage. Let me state here that, to my knowledge, this theory is completely mine! I know of no research or expert studies that indicate such reactions occur due to the amygdala.

Whether or not my theory proves correct, it's obvious that *something* causes average investors to give in to their fears and make decisions contrary to their own best long term interests, needs, and plans. If there is any degree of truth in my theory, then the antidote surely is more information about the origin of our fears.

Volatility has not increased in our time. We are just more aware, due to rapid communication of market movements, with far more observers and commentators watching and informing us, and far more of us involved in the stock market, of changes in the prices of stock.

- People fear that the internet, technology and high tech trading, increasing U.S. debt, greedy investment bankers, and fancy investment wrappers like collateralized mortgage obligations (CMOs), are causing more volatility. There is not one iota of evidence that this is true! We actually have *less* volatility in widely traded stocks than was the case back in the 1930s. (Tell that to our amygdalas!)

- Based on standard deviation, stocks are not any more volatile than in past times, and they may indeed be less so. But I suspect SD is not how market participants, paying too much attention to the day-to-day market movements, experience volatility. Encouraged by CNBC, Fox Business News, Yahoo Finance, Google Finance, etc. etc., all of which spew forth angst all day, every day, fear overcomes common sense.

Many times in these spaces I have urged my readers to stand back from the day to day movements and take a long range approach. I tell my audiences; "Buy good stuff and weed the garden twice each year!"

Better yet, hire someone else to pick the good stuff and constantly stand by to weed the garden as necessary. These people are called money managers or investment managers. I am one. Professional management, by definition, lets us give up any need to stay involved in the markets daily, weekly, or monthly. A quarterly or semi-annual review with your manager of your accounts should suffice.

Know this: any investment proposal which offers significantly higher than normal returns *without* volatility is highly likely to be a fraud. There is no way for stocks to make a steady 10-12% or more annual return, paid monthly or quarterly. Nearly all Ponzi schemes bait their victims with such claims. Bernard Madoff got away with his fraud for years on a multi billion dollar basis. As I write this my professional news websites are outlining several more such schemes which have now come to light. ALWAYS check to make sure such offerings are registered with securities regulators, and offered by licensed securities salespersons. If it sounds too good to be true, it is highly likely it is!

What is happening right now? As this is being written in late June, the stock market remains undervalued on an historic basis.

- A great deal of financial news concerns **economic troubles in Europe**, which are real. However, I believe they are priced in to the current U.S. markets.
- The **upcoming presidential election** is also being priced in to the current rather sluggish markets. As the election campaign continues and a favorite emerges the markets should stabilize. In doing so they should also reflect the positives; high corporate profits, record cash on hand, low price to earnings ratios.
- On the economic side, the **Federal Reserve Board** has sharply reduced its forecast for growth in the U.S. economy for the rest of 2012. It sees unemployment barely budging for now. Until recently many economists were hopeful that the economy would strengthen in the second half of 2012. This optimism has faded as hiring and growth have slowed for the third straight spring. The Fed announced it would continue its programs of stimulus via low interest rates and heavy money growth at least through 2014.

All this surely bodes poorly for President Obama in his reelection bid. As things stand today, in my opinion, he would lose. I base this on various polls which show that he and Governor Romney both being favored by about 45% or so of the "likely voters." What the press does not report is what the other 10% of the voters are probably going to do. History says about 80% of them will vote against the incumbent; this is true of any incumbent, not just Mr. Obama.

If history holds true, unless the race is subject to a very dramatic swing, we will have a new president next year. And we will have a successful businessman in charge, which the markets will surely approve of. This opinion is not a political one in my case, but rather the financial situation as I observe it.

As we approach the Fourth of July holiday, there are few indications that any severe changes in the economy are looming. By Labor Day, we should have a clear handle on the election. But, whatever the outcome of this (or any other) presidential election, remember:

There is almost nothing we can do about volatility. It is, it is irrational, irregular, erratic, completely random, and a fact of life in the markets.

Tom McAllister, CFP

Annual Statements: Our clients and prospective clients are entitled to a copy of our Registered Investment Advisor form ADV II. If you would like a copy please send us a written request at 1098 Timber Creek Dr. #7, Carmel, IN 46032.

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