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Volatility: Friend not Foe

After a surprisingly calm investment environment last year, financial market volatility returned with a vengeance at the beginning of 2018. From the last week of January to the second week of February, global equities dropped 10%, marking the first stock market correction since early 2016.

Of course the headlines cast this statistical concept in its familiar role as "investors' most fearsome enemy".

However, volatility may be getting a bad press. It's not a villain, and it's not always synonymous with portfolio losses.

Of course volatility is necessary, we should not expect a premium for holding equities without it…what is important though is how investors manage their emotions when volatility takes centre stage.

It is also worth bearing in mind that the 'corrections' encountered at the end of January are not untypical of normal market trends, it is just that in recent times we have become accustomed to somewhat lower volatility than is the norm.

Volatility is not directional

A common misconception about volatility is that it implies direction and that, therefore, lower volatility is preferable to higher volatility. In reality, market volatility is simply a measure of the dispersion around the average return, providing no insight into direction.

However short-term volatility is the price for, and indeed a requirement for long-term outperformance.

Historical data demonstrates that over long periods, investors are compensated for holding riskier assets with higher returns than those of less risky assets. Daily account balances may start demonstrating larger fluctuations than in recent years, but long-term investors must resist the urge to make impulsive changes to their investment plans. As Nobel laureate Daniel Kahneman said,

"If owning stocks is a long-term project for you, following their changes constantly is a very, very bad idea. It's the worst possible thing you can do." (Zweig, Jason. 2001. *Do You Sabotage Yourself?* Money (May 2001): 78)

Investors who ignore short-term volatility and follow a disciplined investment plan will realise that when it comes to long-term returns, time is on their side.

…and this is exactly the message that what we promote through Portfolio*sense*®!

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Key activity during the first quarter of 2018

Equities

January saw a continuation of the trend from most of 2017, with equity markets posing strong gains. Progress in the US tax reform saw the S&P 500 rise (by 5.7%), extending the run of consecutive monthly gains to 15. In Europe markets also rose as signs of expansion in the region led Investors to look ahead to the possibility of the ECB exiting its 'ultra-loose' (low-interest-rate) monetary policies. Emerging Markets Index saw strong gains as Chinese banks and Tech companies saw a strong rally on the back of a weaker Dollar and hopes for stronger Global trade growth. The stand out underperformer was the UK with the FTSE All Share Index, down almost 2% on the month as Sterling strength sapped demand for larger, overseas focussed companies such as BP and Shell. This may also have been influenced by talk of the Bank of England raising interest rates faster than previously expected.

However, February saw a dramatic change when equity volatility exploded. The declines were global in nature, with US markets (the S&P 500) down 3.7%, with European markets falling a similar amount, whilst the FTSE All Share fell 3.3%. Emerging Markets were not spared either, with Chinese shares falling 6.36%...its worst month since January 2016. It was the worst February for the S&P 500 in 9 years, whilst European shares fell the most since Brexit, (June 2016). US Dollar strength exacerbated the extent of the falls, with the US Dollar Index seeing the best gain in a year.

So what caused this? Some market participants have suggested that, after a strong run in recent years, this was ***just an inevitable consequence of an overvalued equity market***. Others blamed market technicals (the data generated by market activity) for exacerbating the decline, pointing to ***the forced selling of algorithm-led trading strategies*** (strategies that are pre-programmed to make trades in response to certain conditions). Whilst there will be an element of truth to both of these explanations…the primary trigger for the fall in global equities most likely lies with investors' concern that ***global interest rates are set to rise*** faster than previously expected.

In March, things seemed to calm down, but the tranquillity was not to last. Increasing trade tensions between the US and China spurred a big sell-off in Technology stocks (with the FANG stocks [Facebook, Amazon, Netflix and Google] down 8.2% in March alone). Financial stocks across the globe also fell sharply - down 5-6% in both Europe and the US, the latter seeing their worst performance since January 2016. Emerging Markets and the UK fell around 2%, the latter a combination of Sterling strength (possibly due to the Bank of England's hints of a rate rise in May) and global market weakness has led to 3 consecutive monthly declines for UK shares.

Bonds

January saw negative returns for most major markets, with Gilts losing 2.1%, US Treasuries 1.5% and Bunds down 1%, although Emerging markets bonds saw strong returns of 4.5% as the Dollar weakness boosted sentiment.

February saw European bond prices remaining flat, with UK Gilts actually rising over the month (around 0.3%), taking yields down around 2-3 basis points. The US yield curve steepened at the fastest rate since July 2017, driving down the price of US Bonds, however this had been largely unwound by month end.

As with equities, markets seemed to regain some of their composure in March, despite the confirmation of the Fed's decision on rates. The over-riding factor was the potential growth-destroying effects of a Trade War with China. US Bonds were the strongest since August 2017, up 1% on the month with UK Bonds also strong, on expectations that the Bank of England's pace of rate rises would remain extremely cautious.

Of course, these movements tend to be contrary to those of the equity markets, highlighting the risk reduction benefit of diversifying into an asset class with low to negative correlation with equities.

Property

In January, there was a major contrast between Asia/Japan and the rest of the world in terms of performance. Whilst the former rose 3.5% and 5.8% respectively on the month, all other regions saw declines of 2-3%, with the US seeing falls of 8.9%. Developed markets overall saw 4.9% declines, although it was only down 0.5% if you exclude the performance of the US.

In February, following on from asset price declines in equities and bonds, prices were uniformly lower, ranging from -3 to -5%, once again with the exception of Japan, which was flat. The UK was at the rear of the pack (down 5%), but the US and the Eurozone region saw 4.5% losses.

After a quiet start to the month of March, prices rebounded a little, but then fell away, as Interest Rate worries continued to dominate thinking. A rebound towards month-end left most regions +/- 2%, with Japan and Asia seeing c.2% losses. Eurozone Property rose by 2.5% whilst the UK, (helped by the Strength of Sterling), saw gains of 4.3%. Minor gains in the US left Global Property Indices almost unchanged in March, as the tug of war between Equities and Bonds began in earnest. Dollar returns were slightly higher as the currency showed signs of bottoming out, at least for the present, with UK Property up 6.17% and Europe up c.4.3% on the month.

So why the falls?

Again there are a number of opinions on this subject however I believe that this is driven by the sector giving back some of the gains made over the last few years as a result of the low interest rate policies of Central Banks, as during this time it has been seen by some as a "bond proxy" - an inflation adjusted income stream which, like bonds, falls in price if interest rates rise.

Real Estate Investment Trusts (REITS - the manner in which we hold property) typically have high yields (as they return some 90% of the rental income to investors) and when investors realised that the impact of ultra-low interest rates was not a passing phase, they started to look for a means of replacing the lost yield…and hence bought into this investment strategy. Conversely now, as US interest rates have started to rise the yield gap reduces and interest in REITs has started to peter out.

However, as with Bonds, Property has the virtue of low to negative correlation with other asset classes which is not always pretty but very effective at reducing volatility.

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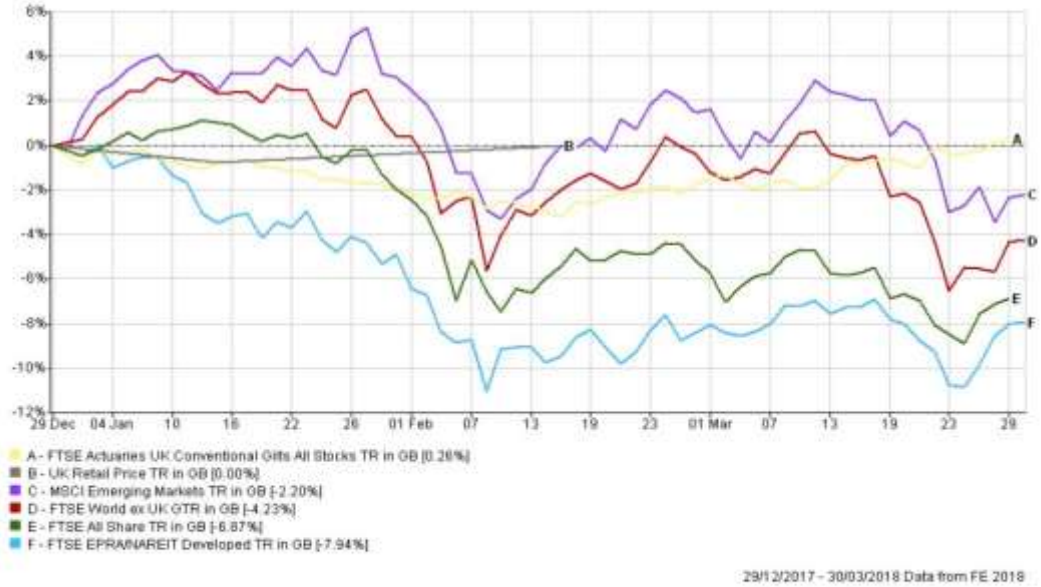
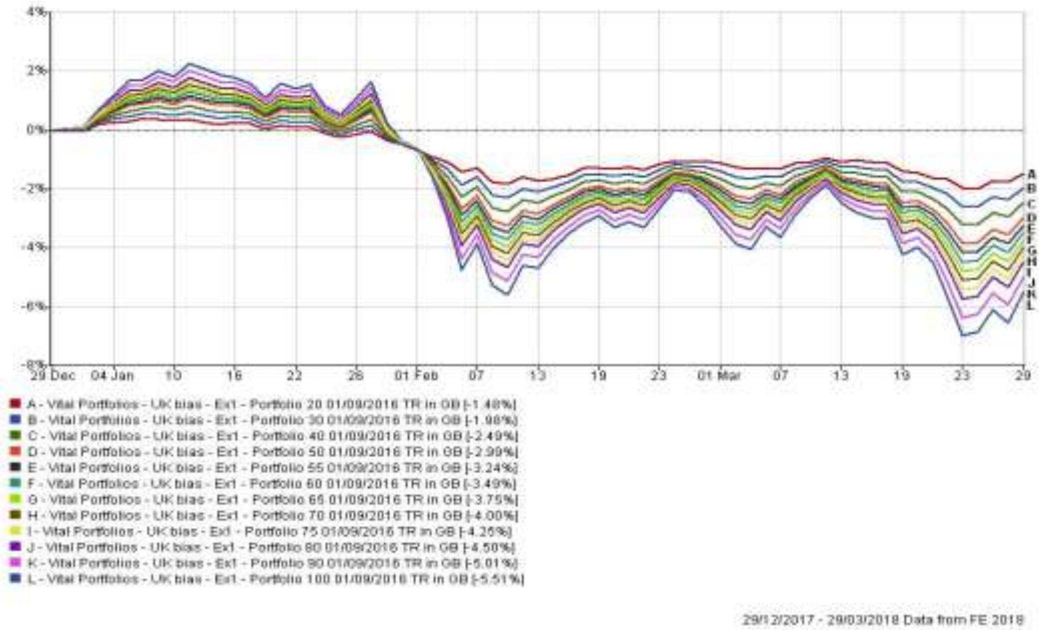
Market Movement over the Quarter



The chart demonstrates movement of markets over the course of the quarter as explained in the above comments.

Portfolio Movement over the Quarter



As is expected of our Portfolio*sense*® strategies, the overall traits of the markets are followed, with performance tempered based upon the distribution between growth and defensive holdings.

Whilst it is never ideal to see investment values fall, the message here is to remain disciplined, stick to your long-term investment strategy and do not be swayed by short term bouts of market volatility.

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For further information please call 0121 313 1370 or go to www.henwoodcourt.co.uk

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Investment Risk Warnings

Please remember the value of your investments and any income from them can go down as well as up and you may get back less than the amount you originally invested. All investments carry an element of risk which may differ significantly.

If you are unsure as to the suitability of any particular investment or product, you should seek professional financial advice. Tax rules may change in the future and taxation will depend on your personal circumstances. Charges may be subject to change in the future.

For each of the portfolios we recommend we are able to demonstrate, using back tested simulated data, the historic returns, the anticipated future returns (allowing for inflation) and the historic downsides (including the worst case scenario that would have been experienced had you been invested throughout the data period), over a variety of time periods.