

# **Taking the Awe Out of Market Shocks**

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### Market Shocks & Investor Psychology

It is axiomatic that no one can know the unknowable or predict the unpredictable. A “market shock” is one such unknowable and unpredictable financial event. Simply defined, a market shock is as an event, unforeseen by market consensus that has a significant impact on near-term investor psychology. In most cases the shock is negative, resulting in a sharp decline in security prices. The following table reflects some of the most important stock market shocks over the past 60 plus years.

### S&P Performance in the Wake of Significant Past Shocks

Event	Date	Next Day's Change (%)	Shock Low Change (%)	1 Week Later Change (%)	6 Months Later Change (%)
Bombing Of Pearl Harbor	12/7/1941	-4.06%	-10.16%	-6.52%	-9.41%
N. Korea Invades S. Korea	6/25/1950	-5.38%	-8.88%	-7.84%	9.87%
Cuban Missile Crisis	10/22/1962	-3.78%	-5.47%	0.23%	26.17%
Kennedy Assassination	11/22/1963	-2.81%	-2.99%	2.25%	12.72%
OPEC Oil Embargo	10/19/1973	-0.77%	-2.37%	1.25%	-14.78%
Hostages Taken In Iran	11/4/1979	-0.67%	-2.95%	0.98%	3.78%
Stock Market Crash of 1987	10/19/1987	-20.46%	-28.44%	-12.27%	-7.22%
Iraq Invades Kuwait	8/2/1990	-3.00%	-6.55%	-4.38%	15.19%
September 11 Attacks	9/11/2001	-4.92%	-13.53%	-8.15%	6.68%
<b>Average</b>		<b>-5.10%</b>	<b>-9.04%</b>	<b>-3.83%</b>	<b>4.78%</b>

Source: Adapted from James Altucher, "U.S. Market: The Great Shock Absorber," *TheStreet.com*, June 23, 2004.

The table illustrates several points. First, the initial shock is unavoidable, but the full effect, that is the *aftershock*, is typically not felt until sometime later. Aftershocks exist because it is human nature to panic during times of distress. Crowd psychology creates distortions in the market and can push the market pendulum too far in either direction. The table also illustrates that “staying the course” is often (but not always) sage advice during times of market agony. More often than not, reacting to a market shock after the fact can do more harm than good since individual investors tend to sell in a panic at or near the bottom.

If market shocks cannot be predicted, and if reacting after the fact only exacerbates the losses caused by the initial shock, then what can be done to lessen their effect? We believe the only logical approach to dealing with market shocks is to use the equivalent of “market shock absorbers” to mitigate their effects on a portfolio. We will further expound on this point later in this Market Commentary.

## *Volatility Unleashed: A Coiled Spring Looming On The Horizon?*

Market shock absorbers will take on even greater importance to the extent market volatility increases. While market shocks are unpredictable, the market's attempt to predict near-term volatility is generally measured by an index called the Volatility Index, or "VIX." The VIX is derived from current prices of traded options. Without delving into the esoterica of option pricing, the lower the VIX, the lower the level of perceived future volatility and vice versa. The VIX level typically vacillates between 25 and 35. In contrast, the VIX is currently trading in mid to high teen range---a relatively low level by historical measures. Therefore, a reversion to the mean for the VIX may result in a noticeable rise in stock market volatility.

If a discussion of the VIX sounds too theoretical, perhaps some plain numbers better illustrate today's low level of market volatility. Over the past ten years, the S&P 500 experienced 757 occasions where its daily return was greater than 1% or less than -1%. This averages 76 large upward or downward moves per year. Over the past 5 years (i.e. during the period when the stock market bubble was developing and subsequently unwinding), the market averaged 95 such large daily moves per year. We acknowledge these statistics may be somewhat distorted by the aberrational nature of the bubble and its immediate aftermath. Yet, over the past twelve months, hardly a period of perceived market calm by most investors, the S&P 500 has experienced only 47 days outside the plus or minus 1% boundary. However, if the market reverts to its historical behavior, increased volatility, and accompanying investor anxiety, may lie ahead.

## *Rethinking Asset Allocation and Traditional Investments in a More Volatile World*

We have always held that diversification is the best antidote to reduce risk. The traditional approach to diversification is to spread assets across a mix of domestic and international stocks, bonds, and hybrid strategies. For example, over much of the past two decades, adjusting the allocation between fixed income and equity investments served to mitigate portfolio volatility. More often than not, when the equity market was weak the fixed income market was strong, and visa versa. However, the question we must ask is whether, and to what extent, will traditional investments be sufficient in a more volatile world?

Under a traditional "long-only" investment approach, investors are essentially taking directional market risk since their investments will generally move up or down with the markets. Although it is true that active managers seek to enhance these returns by "outperforming" some relevant benchmark over time by either "losing less" in down markets or "making more" in up markets, in either case their returns will be largely influenced by directional market moves.

In light of the above, diversification among "long-only" investments has, in and of itself, proven to be an insufficient buffer to volatility. This has been most noticeable during times of distress, when "long-only" asset classes often move in unison. Under such conditions, the only distinction between various asset classes may be that some investments suffer more or less damage than others. For example, as noted in our June 2004 Market Commentary, the April spike in interest rates adversely impacted stocks, bonds, and hybrid securities (e.g. REITs and MLPs) alike. So, while a "long-only" approach has worked well over extended time horizons, it may do little to insulate portfolios in times of increased volatility or in the wake of a market shock.

Of course, market shocks are nothing new to investors, and they are mitigated by a longer-term time horizon as markets ultimately return to equilibrium. However, in the aftermath of the stock market bubble, and subsequent three year bear market, investors' self proclaimed "long-term" time horizons seem to have shrunk

precipitously. In our anecdotal observations, investor skittishness understandably seems to have increased, and reactions to normal market corrections seem to be magnified, in the wake of the post bubble bear market.

Emotional reactions aside, as we have commented throughout the past year, we believe it will be more difficult to earn double digit returns in either the stock or bond markets for the foreseeable future. The simple fact is that since 1982, the stock and bond markets have had a tailwind in the form of a secular decline in inflation, interest rates and capital gains taxes. This secular decline is now over--with all three of these key market-influencing elements having little place to go but up. To what extent this tailwind becomes a headwind, suppressing future returns, remains unclear. However, what is clear is that the tailwind no longer exists and high market returns in all asset classes will be very difficult to come by.

These factors argue for a continued rethinking of asset allocation among traditional asset classes such as stocks and bonds. These factors also argue for a continued rethinking of a "long only" approach to investing; a reexamination of the role that non-traditional investments serve in an asset allocation; and the magnitude of an allocation to such investments.

### ***MDE's Market Shock Absorber: A Strengthened Commitment to "Alternatives"***

While traditional asset classes earn the bulk of their returns from "long only" or "beta" exposure, alternative asset classes earn the bulk of their returns from "alpha" or "uncorrelated" movements in security prices. For example, the returns from a merger arbitrage strategy are largely determined by whether proposed corporate transactions close or break. They are not influenced by whether the Dow drops or rises a hundred points.

Consequently, in hiring alternative investment managers we seek consistency and a return pattern that is largely uninfluenced by market directional moves. In essence, investors are exchanging market risk for more manager specific risk. That is, investors are making more of a bet on managers, their strategies and their talent than on whether or not the broad markets will do well or poorly. Although, no one can guarantee any manager will never lose money, to address this increased manager-specific risk, such managers must also employ extensive risk controls to prevent substantial losses. However, in the event a given strategy does not work during a particular market environment, or if these managers simply make a mistake through human error, by utilizing multiple managers, implementing multiple strategies, screening out high-risk strategies, and employing extensive risk controls, investors can take substantial comfort that any potential losses are mitigated.

To be clear, we do not view alternative investments, or any particular investment approach, to be a panacea. No investment with the prospects for earning anything greater than the risk free rate of return can be viewed as "guaranteed" or a "sure thing." We simply believe that alternative investments provide a different risk profile than traditional investments do and one that is more appropriate in this volatile environment.

In this context, MDE has gradually increased its clients' exposure to alternative investments in recent years. Since 2002 MDE's target level for alternative investments has been 10% of a client's portfolio. Increasing alternative allocations to this level has been a slow and deliberate education process for MDE clients since they generally approach many hedge fund investments with the same degree of healthy cynicism as do we. However, in light of the new market environment, with its prospects for increased volatility and a headwind for traditional long only investing, we believe further increasing the allocation to alternatives is not only a prudent, but a necessary approach to enhancing the risk/reward relationship in our clients' portfolios. Therefore, we are now increasing the recommended allocation to alternative investments to a target level of 25% for our clients' portfolios. We are recommending a *material* increase in our target level for alternative investments so these

portfolio enhancements will have a *material* effect as a shock absorber to buffer future market shocks and the potential for increased volatility.

### Conclusion

In the weeks ahead you will be hearing much more about MDE's increased allocation to alternative investments. We will include an expanded menu of managers and investment approaches such as merger arbitrage, market neutral, long/short equities and other investment approaches that do not have purely "long only" or "beta" exposure. In our view, this is an evolutionary, not revolutionary, approach to our wealth management program that began with the addition of uncorrelated managers in 2002. We view the addition of more alternatives to clients' portfolios as akin to driving a new car with superior shock absorber technology. Our hope is that this improved vehicle will lead us to a smoother path on a most important journey – the fulfillment of our clients' wealth management goals and objectives.

While no one can know the unknowable or predict the unpredictable, we can attempt to reduce the direct financial and emotional impact of future market shocks and increased volatility. Said another way, a restructured portfolio with increased exposure to alternative investments can take the *awe* out of the inevitable market *shocks*.