

Market Volatility – A Perspective

In any challenging business or market environment, there are two main tasks. The first is to understand the major factors behind events and the second (and more important) to quell one's emotions. It is an axiom in investing that the emotional component is a major factor in market losses. If investors act upon the basis of popular sentiment and their feelings of either greed or fear, they invariably end up buying high and selling low.

To insulate themselves from emotional extremes, stock investors have historically researched investment ideas, or else hired a professional advisor to do that research for them. The more you know about a company, the less you are likely to react to a decline in its stock price. With more information about companies available more readily than ever before, it should follow that today's markets would be the most rational in history. This would hold true, but for "the 10% factor". As little as 10% of the market volume is driven by real investors buying or selling individual securities on the basis of corporate fundamentals. *(Source: JPMorgan, June 2017).*

If only a small fraction of investors actually care about the corporate fundamentals in making a trading decision, then who are the other 90% of stock market participants and what drives their decisions? The 90% group is largely comprised of active hedge funds, algorithmic traders, high frequency traders and ETFs. Their influence on short-term share pricing and volatility is often unrecognized and generally misunderstood. To be totally inclusive, mutual funds are also a factor, but their focus tends to be longer-term. They can also maintain cash reserves for liquidity and redemptions.

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The first three in the group are generally pro-active and, in many instances, seek to affect or gain from share price volatility. Any point of change, weakness, scandal, disappointment or even a positive surprise is immediately jumped on and exacerbated for trading profits. Impacting or “gaming” share prices becomes a lot easier in a “thinned out” trading environment without significant fundamental investor participation. Holiday periods are particularly susceptible.

The fourth participant, ETFs are more passive and adhere to more or less fixed weightings in their securities positions. In normal or gradually changing markets, ETFs tend to be net buyers. If, however, everyone starts to run for the door and ETFs experience significant redemptions, then they can add significantly to short-term volatility, particularly given their size relative to the marketplace. We are in the midst of the first significant correction of the ETF era. The “gamesters” play on this.

The bottom line is that investment time frames are now very short and high velocity trading by non-fundamental investors creates both a volatile and highly emotional market pricing environment. The long-term correlation between corporate earnings growth and share prices is high and the opportunities for fundamental investors in volatile markets can be considerable. Short-term markets, however, can be quite irrational as emotions such as fear or greed can be triggered by every manner of event. Even slight surprises (up or down) can result in a “pile on” effect from the active trading entities noted above. We are seeing that now.

One can also add the internet to volatility inducing factors as extreme views, fake news, and simple or unfounded opinions can impact share pricing out of proportion. Market participants are trading stocks, not companies, at those points in time and the influences on the former can be extreme as they can decouple from the basics of long-term investing.

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Remember, your goal is simple, buy low and sell high and not the other way around. Quelling one's emotions is now a basic requirement for today's investor. Also, don't be afraid to capitalize on extreme market moves, because fundamental or value investing does prevail over time.



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December 24, 2018

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