This commentary was written slightly over one year ago. It holds today.
Regards,
T Caldwell

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OPINION

Making sense of the current market volatility

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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) is 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 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 hired a professional adviser to do that research for them. The more you know about a company, the less likely you are to react to a decline in its stock price. With information about companies more readily available than ever before, today's markets should be the most rational in history.

This would hold true – but for "the 10-per-cent factor": As little as 10 per cent of 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 corporate fundamentals, then who are the other 90 per cent of stock market participants and what drives their decisions?

The 90-per-cent group largely comprises 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.)

The first three in the 90-per-cent 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, 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 disproportionately affect share pricing. 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.

Remember, your goal is simple: Buy low and sell high – 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.