Volatile Market- Situation Normal

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The volatility of equity prices and returns during the 21st century have raised questions about the nature of the financial markets. A common one is has the geo-political environment and rapid development of new technologies made the equity market more volatile. To answer this question, we first need to determine if the market has been more volatile during the past 20 years relative to the long-term.

The following table presents the annualized returns and standard deviation of returns for the S&P 500 index over several different time frames. The longest 93-year time frame shows the often cited long-term annualized return of near 10% with a standard deviation of 18.6%. These statistics generally mean that about two-thirds of the time the annual return has fallen in a range of -10% to +30%, which implies that in about one out of three years the return has been outside of this range.

Performance Summary Statistics for the S&P 500

	93-year	50-year	30-year	20-year	10-year
Start	1/1/1926	5/1/1969	5/1/1989	5/1/1999	5/1/2009
End	4/30/2019	4/30/2019	4/30/2019	4/30/2019	4/30/2019
Annualized Return	10.15%	10.15%	10.14%	6.05%	15.32%
Annualized Standard Deviation	18.63%	15.06%	14.20%	14.52%	12.44%

The above table shows that over the past 50-year and 30-year periods, the long-term return has been consistent near 10%, but the measure of volatility has fallen to near 15%. Perhaps, the lengthening of the expansionary stage of the economic cycle has dampened volatility in the equity market. The current expansion is approaching 10 years, which would match the duration of the 1990's expansion. In contrast, expansions during the 1926 to 1969 time frame averaged near 4 years.[1] The US and global economies have changed, but the volatility of the equity market has not increased.

In the 21st century, equity returns have been below normal, but volatility has not increased. This time frame includes the 2000-03 and 2008 equity bear markets. These bear markets contributed to the annualized return of near 6% over the past 20 years, well below the 10% long-term average. Meanwhile, the standard deviation of 14.5% during the last two decades is near the 50-year average.

The most recent 10-year period, which approximates the current economic expansion, has produced above average returns with below average volatility. We should expect that the equity market and economy will eventually experience a painful setback. The key question is when.

Howard Marks, a successful portfolio manager, recently published a book with the enticing title- *Mastering the Market Cycle: Getting the Odds on Your Side*. Shortly into the book, the reader encounters the following statement by the author:

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[1] National Bureau of Economic Research Business Cycles, https://www.nber.org/cycles.html, accessed 05.22.19

See disclosure for additional information

I'm firmly convinced that markets will continue to rise and fall, and I think I know (a) why and (b) what makes these movements more or less imminent. But I'm sure I'll never know when they're going to turn up or down, how far they'll go after they do, how fast they'll move, when they'll turn back toward the midpoint, or how far they'll continue on the opposite side. So there's a great deal to admit uncertainty about.[2]

Uncertainty about the future represents the essence of risk as noted in the following quote from Peter Bernstein, a highly regarded investment analyst and author:

Essentially risk says we don't know what's going to happen. . . . We walk every moment into the unknown. There's a range of outcomes, and we don't know where [the actual outcome is] going to fall within the range. Often we don't know what the range is.[3]

Even when we accept uncertainty, we can still have reasonable expectations about the future. Over the next decade, the economy should grow, corporate profits are likely to expand and stock prices should rise. Additionally, the volatility of equity returns is likely to be higher than the variations in the growth rates for corporate profits and the economy. As compensation for uncertainty, equity investors expect to earn a higher return than holders of bonds and cash reserves.

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[2] Marks, Howard. Mastering the Market Cycle: Getting the Odds on Your Side. HMH Books. Kindle Edition Location 593 of 4413.

[3] Bernstein, Peter. Economics and Portfolio Strategy newsletter titled "Can We Measure Risk with a Number?" June 2007.