



## How Volatility Affects Our Portfolios and Our Psyche

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### **The term volatility continues to gain popularity as a catch-all term to describe “abnormal” market undulations; but what does it really mean? And how does it affect us as investors and as human beings?**

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To be technical, volatility is the statistical measure of the dispersion of returns of a security or index over a certain period. Riskier assets tend to have higher volatility, or bigger movements over shorter periods of time, while low observed volatility tends to be a hallmark of “safer” assets (that does not mean these assets can’t lose money).

### **But when is something volatile? Can it be quantified**

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To more accurately measure how volatile an asset is, we need a benchmark or comparison to properly gauge its relative behavior. The beta of a stock is its relative volatility when compared to the index or group in which it belongs. A beta of 1 means that a stock is likely to be down or up one-to-one with its index, where a beta of two would mean that a stock tends to double the movement of its related index. Other analysts may look at the average historical volatility of an index or stock to get an idea of just how volatile, or “uncertain” its movements could potentially be, and simply assign it a volatility number.

As we explore volatility and its effects, it’s critical to understand that the world we live in today is vastly different from that of past volatile periods in the marketplace. Periods of historical volatility up until the 1990s certainly shook investors, but the speed and complexity of these volatile periods has evolved over the last couple decades. With information now flowing at the speed of light, algorithms driving a large portion of trading and the most interdependent global landscape in modern history, solving the volatility puzzle and predicting when and how markets may calm becomes even more of a challenge. It also means that sentiments can change quickly, and bearish volatile markets could also turn on a dime and morph into bullish ones at a faster pace than history has demonstrated.

Changing market environments and correlations have made it increasingly difficult to hedge against volatility inside your portfolio.<sup>1</sup> At the height of the dot-com bubble, research revealed that the average investor would need at least 50 stocks in their portfolio to ensure that its volatility was

at least the same or less than the broad market. Today, according to a recent study by the National Bureau of Economic Research, you still need at least 50 unique stocks (this can also be achieved through active fund ownership) to be “diversified,” but most investors would have to endure a much higher level of volatility in their diverse portfolios compared to similar portfolios just 20 years ago. That study also revealed<sup>2</sup> a rise in idiosyncratic volatility beginning in the early 1950s and continuing until 2001, yet modern markets see different risks and impacts driven by quickly shifting investor sentiment and the rise of self-directed investing.

*One consistent theme throughout history has been the effects that corrections and erratic markets have on investors; they typically trigger a flight away from assets deemed risky, and into those that offer shelter or perceived safety.*

Today, we are seeing investors exit high-multiple, growth-type stocks while stable dividend payers, value companies and some utilities gain favor. All the latter tend to benefit or offer lower price volatility in a rising rate or skittish market. And even though major indexes like the Nasdaq and S&P 500 have seen drawdowns of 32% and 21%, respectively, there could be more downward pressure in store for the big indexes as markets continue to “assess” appropriately.

## **Unprecedented Economic and Political Occurrences Meet a Dramatic Fed Response**

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The experiences of the last couple of years are quite dramatic when put into the context of the last 13 years, post the Great Recession. Even when taking the volatility and events surrounding the Great Recession into context, the current economic and geopolitical environment is quite extreme. Domestically, the Federal Reserve, in a bid to rein in (self-inflicted) inflationary pressures, is undertaking an extremely aggressive path to tighten monetary policy and slow the velocity and excess of money through the financial system and economy. Typically, higher interest rates tend to force consumers to spend less, while stashing money in a savings account.

But today, we are in an abnormal environment. When the pandemic hit, governments around the world acted swiftly, and perhaps in overabundance, to combat what seemed like another meltdown type event like what we experienced in 2009. Lawmakers launched tens of trillions of dollars in stimulus directly to consumers and businesses alike. Their actions did stave off a recession, but also had unintended consequences, namely inflation and hyper-demand on a global supply chain that was crippled by lockdowns, travel and shipping restrictions and a lack of workers.

So now, the Fed is dealing with record low unemployment and 40-year highs in inflation, with little choice in what can be done. So, after keeping its benchmark interest rate anchored near zero since the beginning of the pandemic, the Federal Open Market Committee (FOMC) has begun raising interest rates at a break-neck pace, with many experts expecting another six rate hikes in

2022 alone. The trajectory is expected to push the effective federal funds rate somewhere between 2.75% and 3.25% by year end, which would be levels not seen since just before the housing meltdown and Great Recession; obviously, you can see why people are nervous.

And yes, these hikes also pushed the prime rate and mortgage rates higher, immediately increasing financing costs for many forms of consumer borrowing and credit. The housing market does appear to be in much better shape, with far more institutional ownership and less leverage than 2005-06; both factors reduce the risk of a crash in that marketplace. Currently, we see it increasingly likely the United States may enter a recession in 2023, albeit shallow. The Fed's response to GDP contraction will predicate just how deep we go as they could certainly reverse course and cut rates if inflation rates cool during a contraction.

Central banks' reaction to higher energy and food prices will prove difficult to predict, as the magnitude or speed of interest rate rises to combat inflation will have to be delicately balanced to support respective economies. The answer will depend on the extent to which higher energy prices dampen growth or alternatively fuel strong wage rises as workers try to protect their purchasing power amid a tight labor market. At the end of the day, the narrative that the FOMC offers, can either offer solace or stress for both consumers and investors.

The Russia-Ukraine war is another wildcard that will complicate the task and effectiveness of the Fed's monetary hawkishness. Its effects add to logistical troubles, corporate earnings (as many western companies have withdrawn from doing business in Russia) and food supply and costs. We believe that the conflict is likely to be drawn out, driving headline risk and continued disturbances, both temporary and permanent, in global trade and logistics.

Volatility has also spread beyond equities and manifested in the already chaotic cryptocurrency markets. Bitcoin, the largest and most well-known and widely held crypto has seen its value drop from nearly \$68,000 in November 2021, to just above \$30,000 in mid-May. And the cryptocurrency market's descent and gyrations have not only taken their toll on the growing number of self-directed individual investors, but also a growing cache of institutional investors who have been scrambling to integrate crypto holdings into larger portfolios. Time will tell if the institutions change their long-term appetite for the budding asset class, but there's no doubt that risk must be reassessed, leading to some regression in the growing trends around crypto.

## **Keep Your Composure, There Will Be Opportunities Here**

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As we move into the second half of 2022 and beyond, we continue to see a unique set of challenges emerge for American consumers and businesses alike. Even as COVID-19 pandemic effects fade, and recent China shutdowns hopefully come to an end, the direct and related impacts (remote work, extraordinary stimulus, substantial cultural shifts, etc.) of how we dealt with the pandemic will linger. Given the complex global landscape and "re-pricing" of the value of equity and debt, there's a strong probability that risk premium and overall volatility in both stocks and bonds is likely to persist throughout the year.

Governments around the globe are now challenged with sparking/maintaining economic growth in a high inflation environment (which is very difficult to do). Without being able to slash interest rates and/or inject money into their respective economies, many nations will be limited on monetary tactics, relying on less effective and harder-to-enact policy shifts. And with no foreseeable solution to the Russia-Ukraine war, energy supply will remain challenged, keeping prices elevated. The region's declining critical exports of wheat and fertilizer also mean that foodstuffs are also expected to see continued unfavorable price and availability impacts. This is likely to further drive prolonged above-trend inflation, eating into household incomes and confidence as the year grinds on.

## **Don't Worry, It's Not All Doom and Gloom, but...**

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Corporate leaders and Wall Street analysts used the first quarter earnings season to "peel off the band-aid" in many situations and dramatically reset expectations for the coming year. So, while a considerable number of stocks are seeing corrections, there will be mispricing opportunities where a particular security is unjustly thrown out. Given our experience in targeting equity value, we believe the expected volatility in the coming months could present a plethora of candidates.

We remain positive on credit with a preference for crossover quality selections, and we expect continued improvements in energy and the securitized sectors in this landscape. Credit spreads remain cheap and there are good risk-return opportunities even if valuations become stretched as spreads are still near five-year lows. In terms of rates, we are underweight duration and see a continued rise in the two- to five-year yields, but a more range-bound target in the 10-year note as monetary tightening will impact growth trajectories.

We're likely to see the U.S. economy decelerate as supply chain constraints continue to dampen manufacturing growth, the Federal Reserve combats worsening inflation with tighter monetary policy, and geopolitical events negatively impact sentiment and cross-border commerce activity.

With nominal rates rising and bond prices falling, equities remain relatively attractive as a hedge on inflation due to their growing earnings and dividend streams. Rising rates will continue to impact the discounting of high-growth stocks' long-term cash flows, resulting in less favor from investors. The hunt for yield is likely to drive interest in select emerging markets as well but expect a more difficult landscape to navigate.

Within equities, we continue to believe the current environment lends itself well to our philosophy of investing at the intersection of quality and value. Our methods seek out companies with proven pricing power to manage through this period of elevated inputs and supply chain variability, along with high return on invested capital, and valuations that are undemanding. Our portfolio continues to target visible and sustainable earnings growth as macroeconomic growth decelerates with a strong focus on fundamentals. We believe this is critical in capturing the return premium at the intersection of quality and value and delivering superior risk-adjusted returns and lower volatility against the benchmark.

## References

<sup>1</sup>Hulbert, M. (2022, May 7). Why it's harder to reduce volatility in a stock portfolio. *The Wall Street Journal*. Retrieved May 24, 2022, from <https://www.wsj.com/articles/reduce-volatility-stock-portfolio-11651859312>

<sup>2</sup>Campbell, J., Lettau, M., Malkiel, B., & Xu, Y. (2022). Idiosyncratic equity risk two decades later. *NBER WORKING PAPER SERIES*. <https://doi.org/10.3386/w29916>

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