MV Capital Management Thought Leadership

Postmodern Finance

A new MVCM thought leadership series providing analysis and commentary on the changing landscape of global markets, economies and national fortunes

Part I – The New Permanence of Volatility

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It's the same thing every day. Actually it starts before bedtime the night before. Japan opens just about when we are sitting down to dinner here on the East Coast. Hong Kong, Shanghai and other regional markets come on line shortly after, and you can get a feel for how the next day is going to play out. Risk on or risk off? You ponder the tea leaves in that final cup of chamomile before retiring for the night. Up early in the morning, now we're in the Eurozone. Anything new on Greece or Italy? What's with those rumors swirling around the ECB? Markets all down by more than 2% - is Wall Street going to follow suit in a couple hours? Maybe, maybe not – Ben Bernanke or China or some random quantum jitter may alter the present reality. Oh look, Dow futures up by 100, even though FTSE is still in the red. Of course that could all go into reverse at 3:30 pm when the high frequency trading algorithms kick into fifth gear.

Trying to make sense of the markets' daily ups and downs is a bit like viewing a Salvador Dalí surrealist painting. You can come up with some interpretation based on what you see, but a deeper objective meaning, such as it may be, is likely to prove elusive.

The one and only constant is volatility. For the 28 trading days between August 2 and September 9 there were 19 days when the S&P 500 closed up or down by more than 1% from its previous close. On 13 days – just under 50% of the time – the change was 2% or more. There were six days in which the price move was 4% or higher. Think about that. On six out of 28 days some combination of events *caused an instant revaluation of common stock prices by more than 4%*. Now, anyone apart from the most committed believers in the Efficient Market Hypothesis understands that in the short and even in the intermediate term stock prices can vary significantly from their fundamental value (which is simply a present value notion for their prospective future free cash flows). But why so much volatility, and why for so long? "Wild Market Swings are Becoming New Standard" reads a headline in the *New York Times* on September 12. Volatility is the new normal, it seems, a permanent part of the landscape.

On the face of it this perpetual volatility does not make sense. A reasonable person can look at one of those 4% days and ask a seemingly straightforward question. Did something happen today at Apple, or Cisco Systems, or Pfizer, that makes their shares 4% more or less valuable today than yesterday? Now, once in a blue moon the answer will be yes – something disastrous happens and becomes public knowledge, like widespread product contamination or the abrupt departure of the entire senior management team to a competitor. But mostly the simple answer is no – the sales contracts are still in place, the factories are humming along, the distribution channels are working as normal. Okay, fine, says the reasonable person. Now I know enough about markets not to be surprised by the odd hiccup – say a 2% move up or down once or twice a year. But if corporate fundamentals are largely the same as they were earlier in the summer, why are these no longer occasional hiccups but rather regular features?

We believe it can be summed up thus: the global economy is going through a profound, far-reaching period of change. There is a higher level of risk baked into the market environment as the full faith and credit of the world's most developed economies – the US, Western Europe and Japan – are less solid than they have been for the past forty years. That is the canvas on which the daily price movements trace their jerky trajectories. And it sheds some light on that mystery of why Apple or Cisco is priced so much higher or lower on any given day. That price – the price of a share of common stock – is nothing more than a single number attempting to reflect what all the productive assets a company has at its disposal –

machines, people, patents, distribution networks etc. – can generate in future cash flows, less the associated liabilities. If you feel very confident that the world in ten or twenty years time will look a lot like the world today then you can compute the value of those future cash flows with a commensurate level of confidence. But if you think there is a high chance that future world will look vastly and unpredictably different from today, your valuation of the company's stock price is much more uncertain, and much more likely to be affected by those random jitters that move markets in the short term. Long term uncertainty does have a direct effect on short-term price movements.

One thing reflected in those manic short-term gyrations is declining confidence in the ability of today's policymakers, or the institutions they represent, to improve the long-term outlook. This is only partly a direct criticism of the policymakers and institutions. It is also a tacit acceptance that the challenges they face are more global than the organizational mandates that define and limit their policy choices. Let us explain what we mean by that. Most of these institutions were established decades ago (if not longer) under economic conditions where national economies were truly *national*. The Fed was founded in 1914, the Bank of England well before that. Production, capital and labor – the raw ingredients of the capitalist system – were national (and capital was tethered to the fixed value of gold). In 1914 a US company that made shirts would buy its material from a US textile company (that in turn would obtain most or all of its cotton from domestic farms), borrow from a US bank to buy sewing and other equipment (also made in the US), hire local workers to man the factory and sell to US stores that would in turn sell the shirts to US customers. Whatever decisions policymakers took that affected the textile and clothing industries there could be no doubt that these were national industries, totally separate from those on other shores.

In the fall of 1907 J.P. Morgan – the man, not the institution – put up his own funds to personally prevent a systemic financial collapse following a run on the Knickerbocker Trust Company that created the Panic of 1907. He succeeded. But the problems of today are far beyond the capacity of wise men (and women) to bestride their white horses and rush to save the day. Some try – US Fed Chairman Bernanke in particular has gone far outside the conventional box of Fed policy tools to try and stabilize the system when it has approached the edge of the abyss. Unfortunately with each successive attempt the results of these tools become less impressive. QE2, the program initiated with much fanfare and market enthusiasm last fall, did nothing to improve the unemployment rate, nothing to improve business sentiment, and in fact inspired some collateral damage by encouraging speculators back into commodities like oil, copper and agricultural products where soaring prices negatively impacted middle class household budgets. In a complex ecosystem like today's markets the emergent outcomes of specific policy decisions simply cannot be predicted with accuracy.

So what do we do? For one thing, learn to live with higher volatility, because it is most likely not going away any time soon. For another, broaden our portfolios to be better hedged against the dominant "risk on / risk off" paradigm, for example through extending the range of "safe haven" exposures beyond the traditional classes of high quality government bonds to include certain currencies and other stores of value. Ironically, the longer this risk on / risk off pattern continues the less risky the "on" trades will be and the more risky the "off" will be, relative to each other. But with very low correlation between them they will offer a natural hedge.

We should be very clear: the permanence of volatility <u>does not</u> necessarily mean a prolonged bear market. It does not suggest that we pull everything out of the market and stuff it under our mattresses. We expect there will be opportunities and perils, as always. But the terrain will be trickier and the need for agility and discipline more urgent than ever. We will continue exploring facets of this new terrain in upcoming installments of this "Postmodern Finance" series.

With warm regards,

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Next in the MVCM Postmodern Finance Series: The Growth Challenge

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