EPIC
INVESTMENT MANAGEMENT

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On Volatility

This is a special, off-cycle, letter particularly written to existing clients. The title is intended as a joke, making fun of money managers who sheepishly refer to stock market sell-offs as "heightened volatility". After all, nobody worries about high volatility when prices are rising. As a spade is a spade, a market drop is just that. Price declines are not muted by using a clever euphemism.

So what are we to make of the recent stock market swoon?

To slightly simplify, there are three types of market declines. The first is a 'pullback', which by default is a drop of less than 10 percent from market highs. As the S&P 500 has retraced less than eight percent from its peak level (closing price of 2011.36), its decline to date falls into this category. Pullbacks are a dime a dozen, and this is at least the fourth of this year.

The second category of declines is a 'correction', which the investment community has uniformly agreed constitutes a drop of between 10 and 20 percent. Some stock market measures, such as the Russell 2000 small cap index, are already in correction territory, and it would be no surprise to see the broader market follow suit.

The third category is a 'bear market', defined as a drop of 20 percent or more. By our count, there have been 13 bear markets since the end of World War II, with eight of these bear markets occurring since 1970.

Pullbacks and corrections can occur at any time, for any reason. Within a few months or a year, we typically forget why the market declined. These are basically random events, quite different from a bear market. And as random events, pullbacks and corrections are difficult to predict. Sometimes the market decides to worry about global growth, or Fed policy, or exchange rates; sometimes the market just needs to catch its breath.

We are now somewhere between a pullback and a correction, and a broad market correction may occur by the time it is all over. This is far from disturbing news, as we held significant levels of cash, bonds and other non-equity assets ahead of this decline. We anticipate that further declines will provide us buying opportunities, and expect to put available cash to work. As a reminder, cash is the least favorite of some eight asset classes we consider for investment; so when cash levels are anything above four to eight percent, it should be considered a sign of a cautious near-

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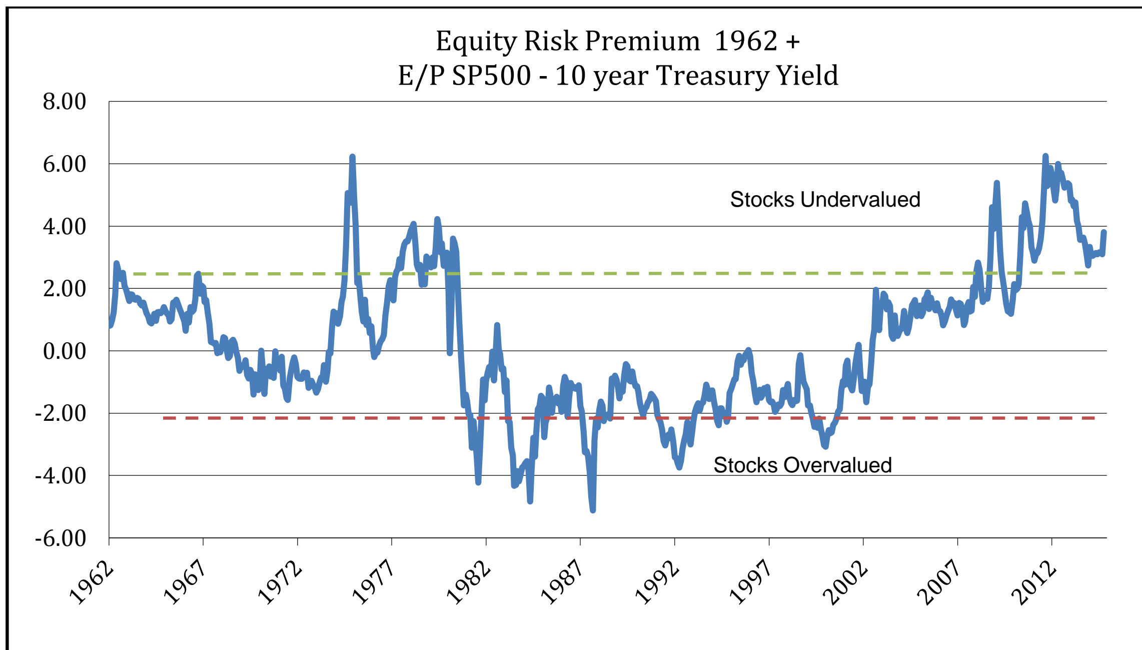
term view, if not outright bearishness. In hindsight, cash levels could have always been higher, but we are not fans of repeatedly trying to outguess the market.

Long-time clients and cohorts will recall that we are also not fans of making market predictions. Nevertheless, our expectation is that this market downturn will not become a bear market rout. It's not that the fears of a global growth slowdown are overblown, or that the Ebola virus threat could not multiply, or that geo-politics have not taken a turn for the worse.

These are all valid concerns, but financial markets always deal with some concerns. During market downturns, these worries become magnified; either the market seems to validate the concerns, or vice versa. On the economy itself, perhaps the late and famous economist Paul Samuelson said it best when he quipped: "Wall Street indexes predicted nine out of the last five recessions". Over three decades, the only worry-free time we can recall was in late 1999 -- just ahead of the bursting of the tech bubble, and a prolonged bear market.

As for proof that our intuition is right -- well there is no proof. In financial markets everything is possible, even when highly unlikely.

In lieu of proof, we offer two insights.



First, as shown above, we can compare the earnings yield (inverse of PE) on the SP 500, versus the 10-year Treasury yield. In a simplistic way, this tells us whether stocks or bonds are more attractive at any point in time. The average spread over the 52 year period is near zero. No bear

market has started when the spread was greater than +130 basis points. The spread is now +380 basis points. Compared to bonds, stocks are cheap, and by a wide margin.

Second, since 1970, there have been eight bear markets. Only one of these, the stealth bear market of 1998, took place without a prior or simultaneous tightening of monetary policy, as signaled by a hike in the Federal Funds rate. The first such hike in this cycle is not expected until well into 2015. We do not consider the end of the Fed's Quantitive Easing program to be a form of monetary tightening. It's just a bad idea that has run its course.

We expect this market downturn to do the same.

As always, we look forward to speaking with you, and encourage your phone calls.

Source:
Bloomberg
Wikipedia