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THE OTTO GROUP

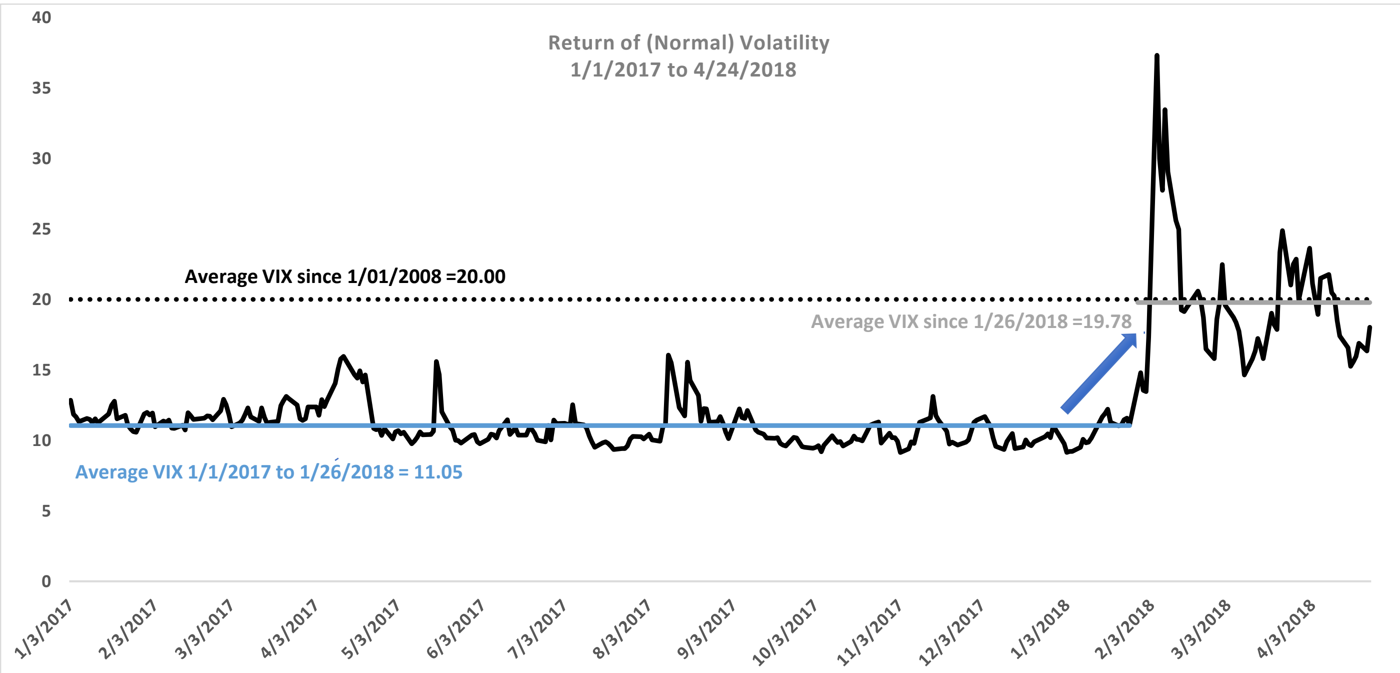
GETTING COMFORTABLE WITH VOLATILITY

Adjusting portfolio risk to help investors adapt to market volatility

The investment environment of 2018 represents a dramatic shift away from 2017's smooth trajectory in equity prices, and investors who grew accustomed to the relentless rise may be feeling increasing angst regarding recent market movements. As a result, the "Fear Of Missing Out" sentiment that grew among investors during 2017 has begun to be replaced with a "Fear Of Losing Money" sentiment, and portfolios/investors whose risk profile increased during last year's complacent environment may need to adjust to endure a more volatile environment in 2018 and beyond.

Return to Normal Volatility

The jump in volatility is actually nothing more than a return to normal. As illustrated in the graph below, volatility (as measured by the CBOE Volatility Index, aka VIX) moved from an average of 11 in 2017 to nearly 20 today – its ten-year average.



Source: CBOE

Therefore, what has felt like a three-standard-deviation black-swan event has actually been a reversion to the mean, and the low volatility of 2017 was the outlier. In historical terms, today's volatility is "normal"; if this creates investor angst, a change in portfolio risk may be appropriate, unless there is reason to believe that the market will return to the abnormally low volatility that preceded 2018.

Trade and Interest Rates Contribute to Volatility

A return to lower volatility seems unlikely. As 2018 unfolds, two key factors – unresolved trade issues and rising interest rates – seem poised to further aggravate investor concerns and market volatility. The potential inflationary impact of tariffs and possibility of additional retaliatory actions, particularly from China, can cloud the economic outlook and dampen investor confidence. In addition, sanctions on Russia, questions regarding Iran and North Korea, and an uncertain outcome to NAFTA collectively suggest that trade issues are positioned to have an outsized impact on U.S. market volatility throughout 2018.

Interest rates also seem poised to contribute to volatility. Higher rates compete with dividend stocks, adversely affect equity valuations, and can compromise interest in gold and crypto currencies – thus creating volatility in a variety of asset classes. The push for higher rates in 2018 is expected to come from several sources: Two-to-three rate hikes from the Federal Reserve; a reduction in the Fed's holdings of treasuries and mortgage-backed securities (quantitative tightening); increased supply, as the treasury finances a record deficit; and a potential increase in inflation. Although these factors are widely known, they will nevertheless impact investor behavior and market volatility as they unfold.

Volatility Alongside Attractive Growth and Rising Earnings
While changes in sentiment, trade, and interest rates may increase volatility, the good news is that they are unlikely to cause an economic downturn or a prolonged market contraction. Our current expectation is that these developments and the volatility they create are set to unfold within an environment of economic strength and increased corporate profitability, driven by global economic growth and U.S. fiscal stimulus. Corporate earnings stand to benefit from top-line growth, manageable wage gains, and lower taxes. Increased corporate investment, which can now be expensed in the current year, could generate productivity gains. The balance of this year will offer investment opportunities that investors will not want to miss, coupled with volatility they will have to tolerate.

Adapting to Volatility
In an environment where fundamentals remain strong, but volatility rises, investors need a portfolio risk level that allows them to maintain their investment structure without the need to shift asset allocation at the wrong time – i.e., when volatility strikes. How much volatility should investors expect? This is an impossible question to answer; however, Strategas Research provides some perspective. In their analysis, they found that volatility increased noticeably in mid-term election years, with the S&P 500 averaging an 18-percent decline. Given the polarizing political environment and upcoming pressures on U.S. interest rates, such a move seems within easy reach at some point in 2018. Proactively tempering portfolio risk to a level that will allow investors to comfortably live through a 20-percent correction will prevent overreaction and panicked selling later – presumably at the worst possible time. Such an adjustment to risk now could also enable some investors to take advantage of a future market correction by strategically increasing allocation to risk assets at lower prices.

Action: Adjusting Portfolio Risk Today
Portfolio risk can be altered in a variety of ways, depending on the asset allocation today and the long-term risk appetite of a given investor. Outlined below are three approaches that adjust portfolio risk to help investors continue to make rational long-term investment decisions in a more volatile environment.

1. The most straightforward approach would be to shift an allocation from **equities to fixed income**. Given the pressures in place for higher interest rates, emphasis on **short duration**, **ultra-short duration,** or **money-market securities** seems appropriate.

2. Portfolio risk can also be modified in subtler ways. **Convertible bonds or high-yield securities may substitute for equity exposure**. Such a shift should reduce equity volatility in a portfolio and increase exposure to small and mid-cap companies that dominate the convertible and high yield markets. Small and mid-cap companies may also be less subject to potential trade war effects that could impact more export-dependent larger companies.

3. Finally, since the sources of market volatility – such as rising rates and trade concerns – are domestically driven, an allocation from **U.S. equities to non-U.S. securities** may be an effective risk-reduction strategy. Such a move can increase focus on investments that are not only less affected by U.S. rates and trade concerns, but that also may be more attractively valued than comparable U.S. companies.

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