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VOLATILITY: FRIEND OR FOE?

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Without a doubt the question that gets asked the most this year is “How do you like this volatility?”. My reply, without exception, is “I LOVE volatility. I do prefer upside volatility to downside though”. The response is a smile or an outright laugh. Of course, nobody I have ever met gets worried about upside price movements in investing.

The third quarter of 2011 clearly experienced both up and downside volatility with the emphasis on the downside. Investors that fully invested in equities clearly saw their portfolios sink in the negative direction.

The market pundits clearly have a daily villain to pin the market movements to. Europe, Greece, US Congress stalemates and other forces are some of the most recent “bad guys” that have given rise to Mr. Market’s negativity. The bigger question is how long will these issues persist?

Clearly established societies, often described as western economies, have some significant headwinds facing them for the next few years. High debt, mounting costs of social insurance programs, and the likelihood of higher taxes to solve the problems. There is nothing new or unique about that last sentence. There seems to be a wide consensus on those points and coupled with the record low interest rates, investors seem to have few traditional options to consider. It appears likely that it will take a few years to resolve these issues and provide a platform for above average growth.

There are a number of strategies that can utilize volatility including Long-Short, Mean Reversion, Managed Futures and Market Neutral. These strategies offer the opportunity to use the markets’ fluctuations as a tool to provide returns in a secular bear market that may continue for a few more years. It’s also important to recognize that while the US and Western Europe maybe having to face the headwinds there are economies in parts of the world that will likely experience above average growth rates for the next few years. For the most part these are the emerging markets including Brazil, Russia, India and China (BRIC).

In the 1870‘s the US was an emerging market the same way the BRIC economies are today’s emerging markets. Whereas the US and Western Europe face many headwinds, some of these emerging economies actually have wind in their backs. Trade surplus, demographics, low debt and low cost of Government are some of the key advantages. These countries’ standard of living is changing to the positive, and they have a large percentage of their population that can move up and be a purchaser of goods and services where previously they could not.

Another important focus will be on income generation. For many years the income portion of an investment in equities was half or more of its return. Only in recent years has the largest portion come from capital gains. We are likely “back to the old days” in order to achieve returns that will offset inflation and meet longer-term investment goals. Opportunities exist in a variety of areas, including real estate, Mortgage Backed Securities, Private Equity and others to have more focus on income as a dominant portion of the total return.

Volatility is going to be with us and it would be wonderful to have the confidence needed to say the emphasis would be on upside volatility, but that is not the case right now. The optimum strategies are to align portfolios with the world we live in today.

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