The INVESTMENT LETTER

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Don't Get Spooked by October Volatility

Have you followed the stock market over the last couple of months? If you have and you've been confused by recent market activity you're not alone. Television's talking heads have been working overtime to speculate/prognosticate/anticipate and otherwise influence viewer opinions of market activity. We'll try to sift through the industry jargon like 'volatility' and 'correction' to provide a clear and honest assessment of what's really going on and if it's reason for concern.

The Dow Jones Industrial Average peaked on September 19th closing at 17,279 with some fanfare as it just recently broke through the psychological 17,000 barrier. From that peak the market then alternated up and down days for the next two weeks before sharply moving downward and settling at 16,117 on October 16th – a drop of nearly 7% in less than a month. Business news was in a panic citing myriad statistics supporting a further drop, recession or worse.

From October 16th through the end of the month, the Dow Jones Industrial Average rallied with barely a hiccup, ending the month at a new high of 17,390 – a gain of nearly 8% – regaining earlier losses and then some. Business news excitedly reported of strong economic indicators and confidently forecast further gains.

What caused such a sharp drop and then immediate rebound? Should I move out of stocks? Should I buy more stocks so I don't miss out on further gains? What exactly is meant by volatility? What is a correction? These are all valid questions that are rarely addressed, much less answered.

First, what we've seen recently is not out of the ordinary for equity markets. By nature they move up and down, sometimes in large increments over a short period of time. While the term correction has been used to describe recent market events, it is technically inaccurate as a correction is a decline of at least 10%. More accurately, recent events can be described as having an increased level of volatility – volatility being defined as the variability, or change in, the price of a security or index.

Understanding industry jargon is one thing but how one uses this information is another. Listening to 'experts' could lead you to believe the only way to profit in such a market is to frequently buy and sell based on predictions. However, few, if any, experts were predicting as sharp a reversal and most were actually suggesting further declines. Listening to this advice would have cost you dearly and that's not even factoring in trading costs or capital gains taxes.

If these types of market movements have you concerned, perhaps re-evaluating your allocation is in order. A market correction is not anomalous and neither are smaller declines – even during a bull market. Since the end of the most recent recession in 2009 the stock market has experienced over a dozen declines of at least 5%. Thus far, the losses in those market declines have been recovered quickly, but that is not always the case.

The best strategy for volatile markets is to stay away if the daily ups and downs are too much to handle. This is unrealistic for most investors who require the attractive long-term gains only stocks can provide. Therefore, a reasonable compromise is limiting stock exposure to a level you are comfortable with.

Also beneficial is to limit ones consumption of economic and market pundits. Consider the source and recognize that their primary job is to keep you watching not making wise investment choices for you.

Market pundits are all too eager to jump on your fears – and there are plenty of things to be concerned about. Escalating tensions and military activity in the Middle East and Ukraine, the European Union seemingly entering another economic contraction, German industrial orders down from expected levels and the growing threat (both real and imagined) of the unknown in the form of the Ebola virus. With so many different market drivers investors are understandably easily spooked.

The best course of action is to have a plan and then follow that plan while ignoring speculation about what may or may not come. Owning high-quality, stable companies, like General Electric, IBM and Proctor & Gamble does not protect a portfolio from declines, but it can insulate it somewhat.

Before jumping into or out of the market or making any changes on near-term volatility take a step back and ask if logic or emotion is driving the decision. If you must move out of the market, realistically gauge the probability you are selling at the right time (hint: the chances of this are low) and consider the likelihood you will again have to foresight to buy back in at the right time (hint: the chances of this are lower still).

When in doubt, seek out a second opinion from a trusted advisor. For the same reason surgeons are discouraged from operating on their own families, so too one should be careful when handling ones own finances. Don't let the short-term noise impact your long-term goals. We've been through this before and we'll go through it many times again.

Perhaps this concept is best summed up from an Investment Counsel newsletter from October 1987, shortly after the market lost 22% of its value on Black Monday. "…it should be remembered that the real money is made from purchasing and holding high-quality growth equities." In the years since, and with the benefit of hindsight, we can see that those that panicked and sold out missed out on an incredible opportunity by letting emotion, not logic, dictate their actions.

Outlook for Stocks

Our outlook for the US market is still cautiously optimistic as our economy is growing unlike that of many other global economies. Many indicators (consumer confidence, consumer spending, unemployment) point toward further gains in the equity markets.

Non-US markets, however, seem to be struggling. The Eurozone is fighting off another recession, with recent reports showing drops in German industrial output, while China, a long-time driver of growth has shown significant signs of slowing as well. Japan is expanding their version of Quantitative Easing (QE) in the hopes of mimicking our results from the program.

Overseas markets can, and do, have an effect on US companies. We will be carefully observing global markets and monitoring the effects on the names we own, particularly those names that have significant overseas operations.

Outlook for Bonds

We expect interest rates to rise, which will decrease bond prices. Industry consensus seems to be mid – to late – 2015 for the first Federal Reserve rate hikes although recent developments suggest its more likely that will be pushed back rather than moved forward. While bonds are still a critical component of most portfolios, providing invaluable diversification and risk management, some types of bonds are more sensitive to interest rate changes than others. Highly sensitive bonds should be adjusted accordingly to limit downside risk from rising rates. On the whole bonds are priced at a premium.

Investment Counsel News

Inside the Office

Earlier this year, as a sign of client appreciation, we subscribed to Kiplinger's Personal Finance magazine for each of our clients. We are excited with the positive feedback we have received! If you have additional family members or friends that would find value in receiving a copy, we would be pleased to add them to our distribution list. Thank you for the overwhelming response.

Outside the Office

Dorothy was able to spend Halloween trick-or-treating with her granddaughter Abby!