Volatility: Friend or Foe?
Portfolio Perspectives

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There have been plenty of pundits chattering about volatility lately and its broader meaning for investors. When will low volatility end, and what will a rise in volatility mean for investors? Monday, February 5th, did mark an end to that quiet volatility period as the VIX (the Volatility Index as measured by CBOE) shot up a record 115.6% in one day. Historically the VIX has been inversely related to the stock market. When market indices are high, volatility tends to be low. It only makes sense that an increase in volatility could make investors nervous about the stocks in their portfolios. As the VIX spiked on February 5th, the S&P 500 suffered a 4.1% drop. But is the news of rising volatility all bad? Perhaps not. Here is a look at some potential positives to an increase in market volatility.

Volatility as Opportunity
We've all heard the familiar colloquialisms of stock market investing: "Buy low, sell high", "Buy the dip", "Be greedy when others are scared and scared when others are greedy." Since these phrases are constantly promulgated by some of the most successful investors, why do so many investors fail to follow these credos? In short, human behavior gets in the way. Many investors see a spike in volatility, a corresponding drop in the stock market and tend to panic. Other investors, however, view these market fluctuations as an opportunity to get into solid investments at lower prices than can otherwise be obtained in a bull market. These investors focus on purchasing investments with solid fundamentals for their potential long-term appreciation and as a complement to their long-term portfolio. The chart below shows that if you would have bought “the dip” in the S&P 500 during the five largest spikes in volatility (previous to 2/5/18), the year-over-year return would have been 14.4%. The three largest spikes would have netted a 10-year return in the S&P 500 of 12.0%.

S&P vs. VIX

If investors bought into the market on days corresponding to the 5 largest spikes in the VIX since its inception they would capture:
Average 1-Year Return: 14.4% (5 largest)
Average 5-Year Annual Return: 12.12% (4 largest)
Average 10-Year Annual Return: 12.0% (3 largest)

Source: FactSet
Past performance is not a guide to future performance.
The market has historically shown many potential opportunities when volatility spikes to “buy low” with the hope of “selling high”. Nowhere is this more evident than during a market correction. Even if companies are posting solid results, market sell-offs can and do happen. What causes this? While there isn’t one precise cause to which investors can point, emotional behavior generally comes into play. Particularly since passive investing and one-click “sell” algorithms have become more mainstream, it is easier than ever for investors to respond to market volatility. Investors with a solid long-term game plan may be able to find opportunities during these times.

**Fall in Love with Rebalancing Again**
Investors—even seasoned ones—can get complacent in the midst of a long bull run. Especially when that bull run is the second longest in history. Stocks have gone up with very little volatility during the last five years. As an example, take an investor with a Moderate Growth & Income allocation five years ago. They were just as enamored as everyone else when the market kept going up and up that they completely forgot to rebalance their portfolios. The portfolio began with 60 percent in stocks and 40% in bonds and had an historical return of 10.2% and a historical standard deviation of 5.8%. Due to the joy of watching their portfolios rise in value, they did not adjust to get back in line.

Five years later, their new portfolio value is approximately $1,700,000, now with a 74/26 mix of stocks and bonds. While they’ve enjoyed the run, they have not realized that they now have a portfolio that line up more with Aggressive Growth & Income investment objective and have historical returns of 12.2% and historical standard deviation of 7.1%. In other words, should volatility return, this investor is likely to experience more portfolio variation than they originally intended. Over the course of time, their “risk tolerance” drifted and became more aggressive as the rate of volatility faded from their memories. The return of high volatility can serve as a positive reminder of why portfolios do need to be rebalanced and constantly monitored to stay in line with investor’s objectives and risk tolerances.

**Bottom Line**
Volatility is a part of investing. It can make for a wild ride at times but can also bring potential opportunities. In any case, it serves as a reminder for clients to reevaluate their risk tolerance and to ensure that their asset allocation is in line with their long-term expectations of what market fluctuations can do to their portfolios.
Notable Quotes

Many notable and successful investors and economists see the opportunity in volatile markets...

**John Maynard Keynes (Economist):** "The markets can stay irrational longer than you can stay solvent."

**Warren Buffett (CEO, Berkshire Hathaway):** “If you are not willing to own a stock for ten years, do not even think about owning it for ten minutes.”

**Francois Rochon (President, Giverny Capital):** Volatility is not synonymous of risk but—for those who truly understand it—of wealth.”

**Christine Lagarde (Managing Director, International Monetary Fund):** "A degree of volatility is OK. The market sorts everything out, eventually.”

**Lloyd Blankfein (CEO, Goldman Sachs):** “Every time I get accustomed to low volatility, like we were towards the end of the Greenspan era, and we think we have all the levers under the control... something erupts to remind us that the idea that anybody is in control of everything is hubris.”

All investing involves risks including the possible loss of principal. Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

Investments in fixed-income securities are subject to market, interest rate, credit and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond’s price. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower rated bonds. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

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Chicago Board Options Exchange Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. An index is unmanaged and not available for direct investment.

The S&P 500 Index is a market-capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market. Returns assume reinvestment of dividends and capital gains distributions.

Moderate Growth & Income: Moderate Growth and Income investors are willing to accept a modest level of risk that may result in increased losses in exchange for the potential to receive modest returns. Historical performance from portfolio of 45% Bloomberg Barclays US Agg Bond / 45% S&P 500 / 10% MSCI AC World Ex US

Aggressive Growth & Income: Aggressive Growth and Income investors seek a higher level of returns and are willing to accept a higher level of risk that may result in greater losses. Historical performance from portfolio of 35% Bloomberg Barclays US Agg Bond / 50% S&P 500 / 15% MSCI AC World Ex US

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