March 2018

Resources Management Corp

MARKET COMMENTARY

E.I.E.I.O. or THE RETURN OF VOLATILITY

2018 has finally delivered what 2017 failed to: the return of volatility in the stock market. According to the WSJ Market Data group, "the absolute daily percentage change for the Dow Jones Industrial Average was 0.31% in 2017. It was 0.30% for the S&P 500 and in both instances, that represents the smallest absolute daily percentage since 1964."[1] Similarly, the VIX, which is a measure of volatility in the market, closed at all-time lows multiple times over the course of the year. In the first few months of this year, however, the story has changed dramatically. Volatility has spiked to levels that have been unseen since 2015, and the daily movements of the S&P 500 and DJIA have frequently been large. Despite the feeling that this shift has increased the risk profile of equity exposures, markets like this provide more frequent opportunities to capitalize on disconnects between the market price and intrinsic value of publicly traded securities.

Many investors have the view that the potential for large moves in market prices makes holding stocks riskier than they were in an environment like the one that was experienced in 2017. For market participants who actually behave as long-term investors, however, this is certainly not the case. Day to day price changes have no actual bearing on the value of a security, and over time, the price of a stock is ultimately driven by the value of the underlying business. Rather than considering daily price movements as changes in the value of your investments, it makes more sense to approach volatility with Benjamin Graham's framework of "Mr. Market" - or for our purposes, "Old MacDonald."

Imagine for a moment that rather than owning publicly traded equity securities, investment was made in a working farm. Based on the farm's historical operations, you are able to construct a reasonable estimate of how much cash this farm will produce annually, acknowledging of course that there will be fluctuations from year to year as a result of changes in commodity prices, weather, etc. From these estimates, you are able to determine a reasonable valuation given the required rate of return that you would need to make this investment.

The farm next to this one is owned by Old MacDonald, who has a very reactionary personality. Every day, Old MacDonald shouts across to you a price for which he will either buy a piece of your farm or sell you a piece of his. Most days the price is reasonable, but occasionally Old MacDonald gets nervous about the weather patterns that have been unfolding or euphoric about a recent change in commodity prices. While Old MacDonald's mood certainly provides opportunities to expand your farm by purchasing pieces of his at a discount to fair value because he is nervous about short-term dynamics at play (and similarly sell pieces to him at prices that are far higher than the farm is worth), his offers have no bearing on the actual value of the farm.

Much like this example, the stock market offers a price to buy or sell a stake in a wide variety of businesses every day. These offers, however, frequently move independently of the intrinsic value of the businesses in question. Volatility is no different than Old MacDonald's offers moving more dramatically as a result of short sighted observations and should be treated accordingly. Volatility increases the potential for better opportunities to buy / sell "pieces of the farm" at prices that are lower / higher than fair value. By taking a long view of the businesses that we are investing in, we are able to capitalize on volatility, treating it is an opportunity rather than as something worth worrying about.

1 https://www.marketwatch.com/story/stock-traders-cheer-return-of-volatility-2018-03-02

Corporate Center West
433 South Main Street, Suite 200
West Hartford, CT 06110
860-561-1245 phone
860-561-1310 fax

866-383-4574 toll free
www.resourcesmanagementcorp.com

P.O. Box 348
9 Bryan Plaza
Washington Depot, CT 06794
860-868-1830 phone
860-868-1834 fax