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Volatility Happens: Putting Market Swings in Perspective

Equity investors felt a recent jolt of volatility after a stellar first half of 2013 which delivered record-setting highs for major market indices. Looking ahead, will the storm clouds pass quickly or will they settle in, making for a turbulent second half of the year?

History shows that volatility can be just as intense in bull markets as in bear markets.

Mid-Year Turbulence

While the S&P 500 declined just 7.5% from its intra-day peak of 1687 on May 22 through its low of 1560 on June 24, the fact that the index lost 5.6% in just four trading sessions (June 19 to June 24) has magnified the market unease for many.[1] Since then, the index has rebounded, gaining 1% in the final week of June and narrowing its loss to 1.5% for the month (after being down by as much as 3.5%).[2] While no one knows for sure what "comes next," there is no denying that market volatility has intensified in recent weeks.

Case in point: In the 97 trading days through May 21 of this year, the S&P 500 closed higher or lower by 1% or more 10 times; by contrast, in just 17 trading days (from May 22 to June 14) the index recorded 11 such occurrences. Yet according to equity analysts at S&P Capital IQ, this level of volatility is quite tame, at least when compared with the past five years. Even on an annualized basis, the recent surge in volatility -- brought on largely by a change in direction for the Federal Reserve's monetary policy -- is less than that experienced in 2012 -- and about half the average level since 2008.[3]

Number of Days the S&P 500 Closed Higher/Lower by 1% or More

	1%+ Daily Close	
Year	**Up**	**Down**
2008	59	75
2009	62	55
2010	39	37
2011	48	48
2012	29	21
2013*	12	9
Average	**41**	**41**

Source: S&P Capital IQ; *As of June 14, 2013.

Market Volatility: A Brief History

Volatility is a fact of life when investing in equities. Since 1960, the S&P 500 has fallen 1% or more in a single day an average of 26 times per year, but it has also risen, on average, 28 times per year during the same period. For the decade ending December 31, 2009, those averages jumped to 40 advances and 43 declines per year, as the market endured two significant bear markets. Today, volatility has receded somewhat to an annualized average of 37 advances and 33 declines per year.[3]

Notably, history shows that the average number of rising days has increased along with the declining days in all decades reported, which suggests that volatility can be just as intense in bull markets as in bear markets.

Near-Term Outlook: Mixed Messages

How should investors interpret recent events in light of historical evidence? Is the recent uptick in volatility a sign of future market woes? Unfortunately, there is no definitive answer. Equity analysts at S&P Capital IQ believe that this period of decline may have already run its course and will likely end up as "noise" (a decline of up to 5%) or possibly conclude as a pullback (a decline of 5% to 9.9%).[3] Yet other S&P data suggests that we are entering the most volatile period of the year. Specifically, since 1945 volatility within the S&P 500 has been 25% higher in the third quarter than in the other three quarters of any given year.[2]

Finally there is the momentum factor to consider. Despite recent declines, the S&P 500 posted a 12.6% price gain in the first half (H1) of 2013 versus an average 4.1% advance for all first halves since 1945. And history shows that whenever the S&P 500 has risen in H1, it has gained an average of 5.4% in the second half (H2) of the year; further, if the H1 gain has been greater than 10%, the market has advanced an average of 7.5% in H2.[2]

Strategies for Managing Volatility

So whatever guidance you choose to subscribe to, as a long-term investor it is important to maintain perspective on your own goals, avoid the daily barrage of investment news, and consider some commonsense strategies for managing cyclical bouts of volatility.

- Don't panic. Don't sell into a rapidly declining market and don't buy into a rapidly rising market. You'll just be following the herd and locking in losses. Panic sellers also run the risk of missing the market's best-performing days.
- Watch your asset allocation. During volatile times, more risky asset classes such as stocks tend to fluctuate more, while lower-risk assets such as bonds or cash tend to be more stable. By allocating -- and monitoring -- your investments among these different asset classes, you can help smooth out the short-term ups and downs.

- Diversify. Different sectors tend to outperform or underperform in different phases of the business cycle. For instance, in the depths of a recession (like 2007 and 2008), defensive sectors such as Utilities and Consumer Staples often outperform. In the height of a boom, Information Technology or Materials companies are more likely to outperform. Likewise, different size companies and different investing styles (e.g., growth and value) often take turns outperforming one another.

- Consider buying opportunities. Although investors may be gun shy in the wake of heightened market turmoil, one strategy you should seriously consider is selectively adding to your portfolio. This is especially true when prices are low versus historical averages. A systematic purchasing plan, also known as dollar cost averaging, can help in volatile times, as it provides for regular purchases over a period of time, taking the guesswork out of specific timing of purchases.

[1]Source: S&P Capital IQ, Global Equity Research, "Resilient Rebound?" June 25, 2013.

[2]Source: S&P Capital IQ, Global Equity Research, "Buy in July?" July 1, 2013.

[3]Source: S&P Capital IQ, Global Equity Research, "Rising Volatility and the Risk of Decline," June 17, 2013.