MATARIN CAPITAL

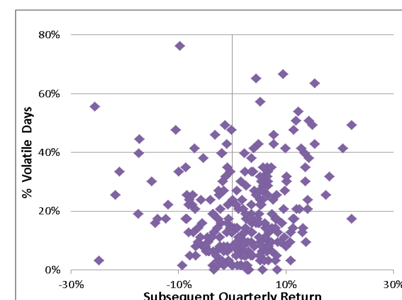
Investing with Insight and Integrity

When Opportunity Knocks

March 2016

Stock market volatility makes investors nervous, despite the fact that market history suggests that volatility alone is not sufficient to signal that markets will decline. The recent period has been no exception. With markets staging many substantial single day moves during Q1'16, cautionary tales about market volatility have become common. So at Matarin we asked two key questions: How volatile is the current period, really? And how should investors respond?

S&P 500
% of Days in Quarter with >1% Market Move vs. Subsequent Quarterly Returns



Riding the Roller Coaster

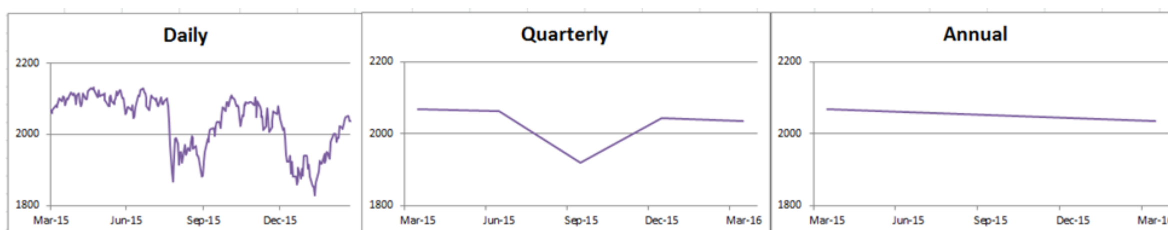
As a simple measure of volatility, we consider the percentage of days on which the S&P 500 has moved up or down by more than 1% during the past quarter. During Q1'16, this occurred on 43% of the days in the quarter, among the top 10% of all quarterly observations since 1950. So the current period has indeed been risky. However, as you can see in the graph at the right, quarters with extreme volatility are followed both by quarters with positive returns and quarters with negative returns.

Also on a global basis, high volatility quarters are not a reliable signal of future market direction. As you see in the table below, when we look over a period dating back to 1995, we find quite a variety in observations across countries, with no compelling trend. This inconsistency suggests that volatility alone is not sufficient cause for panic (or euphoria).

	Australia	Canada	China	Eurozone	Hong Kong	Japan	Mexico	U.K.	U.S.
Average Return After 10 Most Volatile Quarters	2.6%	-0.6%	4.9%	8.7%	-1.6%	-0.3%	2.1%	1.3%	3.1%
Whole Period Average Quarterly Return	1.2%	1.5%	3.4%	1.5%	1.6%	0.4%	3.8%	0.9%	2.1%

Running to Stand Still

A common response to heightened volatility is fear when markets are falling, causing a desire to sell. Because volatility spikes are shorter-term phenomena, they heighten investor awareness and attention on a short-term basis. In behavioral finance, the overconfidence bias tells us three key things: that information overload leads to overconfidence, that overconfidence leads to overtrading, and that overtrading leads to underperformance. Consider the difference in perception revealed by looking at the past year's S&P 500 chart on a daily, quarterly, and annual basis. At the end of the day, not much has happened at all.



Moody Mr. Market

Volatile markets may still be a valuable tool for investors in generating returns, even though—as demonstrated above—the volatility itself should not be a guide. The emotions associated with dramatic market swings create mispricing opportunities which can greatly benefit a cool-headed, long-term focused investor. In 1949, legendary investor and author Benjamin Graham wrote an allegory about emotion-driven markets, in which the stock market was personified as a manic depressive called Mr. Market. Each day, Mr. Market comes to your door and offers you a trade. He is always buying or selling the same asset, and the "fair" value of this asset doesn't change very quickly. But Mr. Market, being a manic depressive, offers prices for the asset which gyrate wildly from day to day based upon his mood. The lessons are 1) don't let Mr. Market's moody price swings affect your opinion of what the asset is truly worth, and 2) use the emotional price swings as opportunities to buy from Mr. Market when the price is low and sell when the price is high.

At Matarin, this is exactly how we view volatility in emotional markets – as a source of opportunity. Our return forecasts are long-term in nature, and because our ideas are implemented systematically our investment process is not subject to "emotional contagion" from Mr. Market's manic depressive mood swings. During periods of heightened volatility, investors may profit by leaning into the winds of fear and greed to find budding opportunities to turn risk into reward.

Source: Bloomberg

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