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Volatility is returning, what should I do?

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If you don't like market volatility, you're not the only one. We manage our clients' investments and we are also investors in the same portfolios, so we feel the same pain. It is not pleasant when our portfolio values decline. However, portfolio managers who are trained and have seen various episodes of market volatility can handle it with more conviction than those who are not trained. In this month's commentary, we will explain how to manage volatility.

Many investors say they do not like volatility. Oddly enough, they do not complain when their portfolio value is rising – which is still volatility, but on the upside. Realistically, what investors do not like is downside volatility. Avoiding downside volatility can be achieved by holding money in cash – it earns no interest at the bank, but the value does not go down. The challenge is that the purchasing power of our money declines as a result of inflation. While the overall Canadian inflation rate is less than 2%, your personalized rate of inflation may differ, depending on your shopping basket. For example, meat prices have been rising at an average rate of 5.1% over the last three years. Most of us, unfortunately, did not earn 5% interest from our cash savings, nor has our salary grown by 5% to offset the increasing cost of living. While our $100 bill still says $100, we are only getting 85% of the meat we used to get three years ago with that same $100 bill. If you buy an abundance of audio and video equipment, such as a big-screen TV, Blu-ray player, etc., the good news is that the cost has been deflating at 6% per year over the last three years. However, most of us need to invest our money to counter inflation and, therefore, we have to live with some volatility.

The question is how much volatility you can tolerate. There is some art and science to help assess this question. Let's start with science. In general, those who do not need their money in the near term and hence have a long investment horizon can invest more heavily in the stock markets, which provide a premium to fixed-income returns. As I said earlier, volatility is measured both in terms of upside and downside. If you want more upside, it also comes with occasionally larger downside. If you are able to hold your investments for longer, downside market volatility is merely noise, not losses, as it is likely that the decline in value will eventually be recovered. It should not affect your investment plan, and most importantly, your lifestyle.

What about those who do not have the same luxury of investing for the long term and need to spend their money on a continuous basis, say, to buy meat or a big-screen TV? The bad news is they will earn a lower premium as their investment portfolio cannot be dominated by stocks. The good news is that a well-crafted, diversified portfolio can still help you to beat inflation without exposing the portfolio to enormous downside volatility. It is a reasonable tradeoff between inflation protection and tolerating some modest volatility.

So where does art fit in to this conversation? To begin with, all of us are not created equally. We react differently and we have different needs. Some of our clients may have long-term investment horizons but have a low appetite for volatility. This means that every time the markets fall, they become uneasy about their investments and lose sleep. While a portfolio with more stocks may be appropriate for them, they are better suited to portfolios that carry more fixed income. The opportunity cost is a lower return but they “earn” a better sleep at night and their investments may still beat inflation. There is nothing wrong with that.

Both your advisor and our team of experts believe investing is about you, not about the markets. We do not try to predict the short-term directions of the markets. We create portfolios and your advisor recommends one that is relevant to your investment horizon and your risk tolerance after considering both the art and science.

I hope that you feel better about your investments and understand that there is a process at work to help you achieve your goals. In brief, the recent downside volatility in the markets reflects how investors’ risk appetite has fallen as a result of 1) poor liquidity during the summer 2) unexpected devaluation of the Chinese currency, which led investors to believe the Chinese economy is slowing more rapidly than expected 3) ongoing concern that the U.S. will raise interest rates.

Inside our portfolios, we have been positioned for a slowdown in the Chinese economy for some time by having a low weighting in Chinese equities and low exposure to the energy sector. We have been waiting for opportunities to purchase securities and, thanks to this correction, we believe these opportunities are getting closer. As a result of a slowdown in the Chinese economy, which will likely affect the global economy, we expect a slower pace of interest rate hikes, not just in the U.S., but globally. A backdrop of low interest rates, low inflation and slow growth can be interesting and we remain constructive.

Combined top 15 equity holdings as of August 31, 2015 of a representative balanced United Financial portfolio with alpha-style equity exposure:*

1. Manitoba Telecom Services 2. Atco 3. Altagas 4. Empire 5. E-L Financial	6. Resorttrust 7. Loblaw Companies 8. Suncor Energy 9. Citigroup 10. Google	11. Canadian Tire 12. CIBC 13. Industrial Alliance 14. Toronto-Dominion Bank 15. Banca Popolare dell’Emilia

Combined top 15 equity holdings as of August 31, 2015 of a representative balanced United Financial portfolio with value-style equity exposure:*

1. Toronto-Dominion Bank 2. Apple 3. Royal Bank of Canada 4. Microsoft 5. Bank of Nova Scotia	6. American International 7. Manulife Financial 8. CIBC 9. UnitedHealth Group 10. Citigroup	11. Google 12. Tokio Marine 13. Anadarko Petroleum 14. Novartus 15. GlaxoSmithKline

*Approximately 37% fixed-income, 7% enhanced income, 49% equities and 7% global real estate.

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Portfolio Construction

To see the top 15 holdings of the individual United Pools or of the United equity Alpha mandates, please visit the United Financial web page by right clicking on this link and selecting "open web link in browser": http://www.assante.com/wp/optima/financials.jsp#united15.