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Client Newsletter – April 2018

The Return of Volatility

Since the election in 2016, I have cautioned our clients to pay attention to the fundamentals of the markets and the economy and ignore the headline news. That advice has served us well during this time. Events that were unbelievable, except they happened, rocked the markets, causing periodic turbulence. Still the economy improved over the moribund previous years, and the markets rallied strongly. But, had you watched CNBC and taken their comments to heart, or read newspaper headlines, you could be frightened out of your mind. Many investors were frightened and fled the market, to their detriment.

The year 2017 was a remarkable year for investors, despite the political turbulence, as the market surged during this period of remarkable calm as measured by the volatility index. According to the volatility index (VIX), volatility never traded above 19 all 2017.

The VIX, a way of measuring market risk, was only recently developed after market crises. Subsequently investment vehicles to invest in the VIX itself were developed. The idea of volatility and investing in volatility, as a measure of risk, goes back to the days of Mesopotamia.

As the volatility index moved from a measurement to a target for investment, the concept changed. When I was a child in my family store, my father taught me that if you observed something you could change it. Much later, I learned that physicists had themselves learned this phenomenon, and labeled it the "observer effect", among other things. In finance, the equivalent was Goodhart's Law, named after a British economist Charles Goodhart. Goodhart argued in 1975, that once a measure becomes a target, it loses the very properties that made it a good measure. Thus as more and more people incorporate volatility into their models, they change its nature.

Why do we care, you may ask? The reason is that volatility has become much more pervasive as a result of these volatility investment vehicles. Not only does investing in volatility make the VIX more volatile, it affects the entire market.

So, compared to 2017 when the VIX did not exceed 19, volatility has returned to the S&P. In fact, one horrific day XIV, a trading vehicle for Exchange Traded Notes lost 94% of its value in a single trading day. This terrifying slide translated into one of the swiftest percent drops of a security in market history. Global equities lost $4.2 trillion that week. For those of you that ignored the headlines and stayed invested, that drop was a nonevent. Investors in XIV did not have the choice of staying invested as that ETN fund, which had been valued over $2 billion in January, was closed.

The markets went from finding a gauge for volatility into trading the gauge, to a wipeout. Fortunately we do not invest in derivatives, but others were not so fortunate.

The lesson here is that investors will experience volatility, which is inevitable. Volatility is here to stay. A further observation is that markets tend to become more volatile as they reach their peak. Investors become indecisive and less inclined to invest, which takes some of the upwards bias from the market. We can't be spooked by volatility, but we will observe it and its effect on the markets, in order to take appropriate action at that time.

In spite of volatility, the global economy continues to strengthen. Forecasts are for global economic growth of 3.9% for the next two years. This could be the beginning of a new bull market…Unless policy mistakes intervene.

Best,

William D. Rutherford
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