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Investment Insights

From RE Advisers, Investment Advisor and Administrator for Homestead Funds

Homestead Funds

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What is Volatility?

The VIX, or Fear Index, has been elevated since the start of the financial crisis, with periodic aftershocks. The VIX is often a headline grabber — it's considered an indicator of bearish sentiment at higher levels.

Throughout this issue, we take a closer look at volatility: what it measures, what factors are likely contributing to the higher levels seen in the second half of 2015 and so far in 2016, and how our portfolio managers assess the situation.

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Volatility: Cause & Effect

To start, what is volatility, and how important is it to smart long-term investing? There are a number of ways that volatility comes up in portfolio management.

Volatility, Backward and Forward

First, we can look at the past. Tracking the long-term volatility of a particular asset class or security can tell us a lot about an investment. Using the standard deviation of historical returns for a long period like five or 10 years, we can see how that investment has behaved in the past, and how it tends to mirror or counter other investments.

With this information, we can understand the role of each investment in a portfolio. In turn, we can help our investors understand what portfolio mix is right for their needs and risk tolerance. This backward-looking measure is a fundamental building block of portfolio design.

The past can also tell us if recent movements in the market have been greater or less than is typical for historical periods. For instance, if we measure medium-term volatility by tracking the trading range of the S&P 500 Index over two years, we get a sense of the broader trend for stocks. While market movements could be high from day to day, a step back may show that the market has been calmer than we thought.

Yet another measure of volatility, the CBOE Volatility Index (VIX), looks forward. The VIX represents the implied volatility in S&P 500 put and call options traded on the Chicago Board Options Exchange (CBOE). It tells us how wide-ranging investor expectations are for the year ahead.

At elevated levels — generally considered to be 20 or above — it suggests that investor psychology may be driving price swings rather than company fundamentals. For active portfolio managers, that disconnect can create buying opportunities.

The VIX: Higher measures reflect higher uncertainty

Source: http://www.cboe.com/micro/vix/historical.aspx

The VIX as a Fear Index

Technically, the VIX measures the range of anticipated returns for the S&P 500, but it doesn't have much predictive power. It can be a useful barometer for investor sentiment though, as it tells us whether investors' fears about short-term losses are heightened or diminished. It tells us whether investors' fears about short-term losses are heightened or diminished.

"We don't care much about market prognostication, but we care a lot about whether individual investors — our clients — are growing fearful. Making investment decisions based on emotion can ruin a portfolio."

We don't care much about market prognostication, but we care a lot about whether individual investors — our clients — are growing fearful. Making investment decisions based on emotion can ruin a portfolio.

Thanks to ingrained loss aversion, investors tend to spook when markets are falling. Anxiety goes up at the first sign of loss, and some investors are prone to selling investments rather than sticking to the long-term plan. We also know that's historically the worst time to sell; market timing is notoriously tough to get right, and easy to get catastrophically wrong.

Volatility Today

Our portfolio managers offered thoughts on what's driving the periodic volatility in today's markets. Read on to see what our team really thinks about volatility — and where they see the silver lining.

Investing in an Election Year

Do elections matter when it comes to markets?

Yes — and no.

Yes, in the sense that the presidential election could — eventually — have tangible implications for investors. Things like tax code changes, regulatory and fiscal policies, and our country's relationships, from the diplomatic to the economic, really do matter. These big picture trends affect both single companies and the broader economy.

But we can't indulge ourselves too deeply when it comes to the "what ifs" of an election. Research studies are divided when it comes to understanding if and how presidents and parties affect stock and bond markets.

Some studies suggest stocks outperform under Democrats and bonds under Republicans; others find the Democrat stock premium applies only to small company stocks. And still other studies find that all of these patterns disappear depending on what time period you look at. Taken together, the research suggests the election outcome is probably not as important to markets as we might imagine.

What's perhaps more important: every presidency coincides with a unique economic and political backdrop, a very specific point in the trajectory of history. It's tough to untangle which element had the biggest effect: the president, the party, the balance of power in Congress, the broader economic cycle, or even the meta-cycles of technological eras.

A Source of Uncertainty

Whether or not the next president will have tangible effects for companies and economic trends, one thing is for certain: an election introduces uncertainty into markets.

Campaign rhetoric and other news headlines tend to rattle investors' nerves. The uncertainties from the campaign trail can set off swings in industries or even in particular stocks. One candidate may skewer pharmaceutical pricing practices, while another talks of breaking up banks and a third preaches health care reform. The mere thought of regulatory changes can send investors on a tear. Does that mean such changes will ever come to pass? No, but the mere uncertainty can move valuations.

Favoring Companies Over Campaigns

For our portfolio managers, the long-term trends facing company managements are always the priority over political chatter and "what ifs." The implications of a political leader may vary for each company. That's the real work of a portfolio manager — to track individual operations, understand the path of a company and tease out the real effects of the challenges and opportunities it faces.

Who's Better for Stock Markets? Depends.

	DEMOCRATS	REPUBLICANS
Average stock market performance across all presidencies since 1945	✓ 9.7% annual average returns	6.7% annual average returns
Top stock performance of presidential tenure	14.9% under President Bill Clinton, 1993-2001	18.6% under President Gerald Ford, 1974-77 ✓
Presidents with negative annual returns over tenure	✓ None	-5.1% under President Richard Nixon, 1969-74 -4.6% under President George W. Bush, 2001-09
Average stock return considering control of Congress	2nd Place Democratic president facing Republican Congress or split Congress	1st Place Republican president with Republican-controlled Congress ✓

Source: http://money.cnn.com/2015/10/28/investing/stock-market-democrats-republicans/

Macro Market Bullies: Oil and China

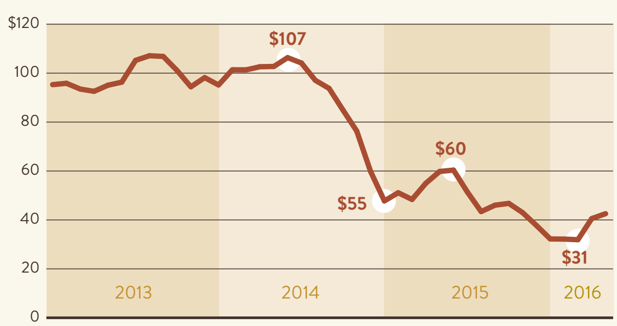
Some days, it seems the whole market rides on a single data point — an unexpectedly low inflation report, or a higher than anticipated jobs number. Such macroeconomic measures may have little effect on stock or bond picking, but a large effect on day-to-day or longer term swings in valuations for markets.

Anyone tracking current headlines could name the top two macro bullies of the times — oil prices and economic activity in China. Both issues are introducing considerable uncertainty to market sentiment.

OIL: Climbing Supply, Falling Demand

Oil prices have been in freefall since mid-2014, tumbling from the peak of $107 per barrel, down to the mid-$20s in early 2016 before recovering somewhat. Market sentiment and stock valuations have largely followed for the same ride.

Oil — $ per Barrel



Source: West Texas Intermediate Crude, from the St. Louis Federal Reserve. As of 4/16. https://research.stlouisfed.org/fred2/series/DCOILWTICO/downloaddata

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Both supply and demand are responsible for falling prices. Globally, the daily production of oil was up 8% between 2010 and 2015. The uptick in oil production in the U.S. is one major factor, as American oil production climbed an astonishing 55% in that five-year period. Back in 2010, the U.S. was producing about 11% of the world's oil; today it's closer to 16%.[1] Meanwhile, demand for oil has been flat or even falling in some places. In the U.S., oil consumption is down about –2% between 2010 and 2015; for all Organization for Economic Co-operation and Development countries, it's down about –5%.[2]

CHINA: Slowing and Uncertain

Slowing activity in China is deeply entwined with falling oil prices.

Just a couple years ago, many were forecasting a gloomy scenario of "peak oil" — unmitigated demand, especially from China, pushing prices over $300 per barrel. Instead, as China's growth moderated, oil prices plummeted.

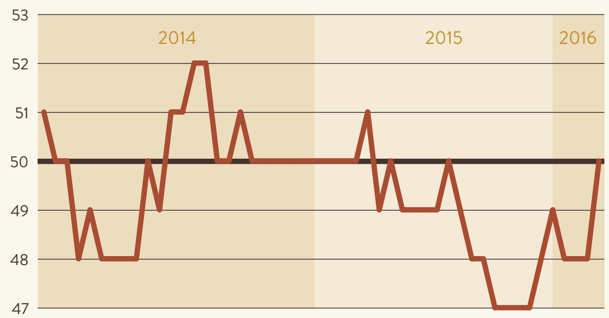
So how much is China really slowing? The country's reported GDP has gone from 7.7% annual growth (inflation-adjusted) in 2013, to an estimated 6.9% in 2015. From the standpoint of the U.S., which hasn't topped 2% growth in the last three years, the difference between 7.7% and 6.9% seems minor.[3]

[1]Source: U.S. Energy Information Administration. Data as of 10/31/15.
[2]Source: U.S. Energy Information Administration. Data as of 9/30/15.
[3]Source: World Bank. Data as of 2/29/16.

Issues like oil prices and China's growth are relevant — but secondary — when it comes to our investing process.

China's Manufacturing Activity

(below 50 indicates contraction)



Source: China Caixin Manufacturing PMI Index, from www.investing.com/economic-calendar/chinese-caixin-manufacturing-pmi-753. As of 4/16.

But some areas of China's economy have clearly slackened. Manufacturing activity, as measured by the China Caixin Manufacturing PMI, has spent more time in contraction territory than in growth territory over the last year. Recent readings have perked up, but the longer trend has been lackluster.

The numbers don't appear extreme. Yet, there are two underlying issues: first, that some investors suspect China is careening toward a "hard landing," a result of central planning that may have encouraged sham building projects, doomed bank loans and other misaligned economic activity. The other worry is that the numbers, rosy as they are, are not trustworthy. Perhaps the real GDP growth rate for the country is not 6.9%, but 5.9%, or 4.9%. Only time will tell.

Putting Little Stock in Macroeconomic Measures

If nothing else, the conundrums of these measures — why oil has fallen so precipitously, yet the numbers out of China don't appear disastrous — are proof of just how complex macroeconomic factors really are.

It's not just that oil demand from China has fallen off; it's also that supply is up and technological gains are starting to curb developed market demand in a significant way. And for China, the wild gyrations in the domestic stock market seem to be telling global investors that there's more to the story than official numbers suggest.

Both metrics are also good examples of how quickly macroeconomic measures can veer from expectations. Lucky for us as bottom-up investors, these developments do not affect every company the same way; for some, they're very important, for other firms, these things are inconsequential. As such, issues like oil prices and China's growth are relevant — but secondary — when it comes to our investing process.

The Bright Side of Volatile Markets

If uncertainty is the cause of volatility, what is the effect? Opportunity, say our portfolio managers. A jumpy market may not change their investment process, but it can open up windows of opportunity to put their valuation discipline into practice. We got their thoughts on the situation.

Q: What's your take on the current volatility in the stock market?

PRABHA CARPENTER: When stock prices are falling quickly, or when they're bouncing around a lot without making upward progress, it can really rattle investors. But for value investors like us, volatile periods can sometimes present the opportunity to buy a new stock, or add to a position that we really like, for what we believe is an attractive valuation.

We aren't doing anything differently in terms of how we research or evaluate companies. Our job as portfolio managers is to focus on the things that we can know and control, instead of fretting about the things we can never have any certainty or control over.

Volatility is in the category of "unknowables," things that we can't predict — when it will start or stop, if it'll get better or worse.

Q: If market volatility falls into the category of "unknowables," what are the "knowables" that you do focus on?

MARK ASHTON: Our job as portfolio managers is to exercise good judgment about which companies to invest in, and when. Our goal is to own high-quality companies that are well positioned today and likely to adapt well to changes in the future, and we are careful to get into stocks at what we believe to be reasonable or discounted valuations.

An important factor in the process is our assessment about a company's management team. We may study a company for a few years before we feel we have sufficient confidence in the management. How do they work through challenges? Do we think they will be successful in executing their strategy?

From our perspective, those are the decisions that we have control over. We try to find great teams who are positioned to take advantage of a long-term theme in the market.

Q: Why do you think market watchers tend to be so focused on things like volatility or macroeconomic factors?

MARK ASHTON: People will naturally focus on the big movements and then they want a simple way to rationalize them. Investing our way may appear uneventful, even boring to some investors.

Our method often involves waiting, waiting for your expectations about a company to materialize, or waiting for the right price to buy a new stock. It's not a style of investing where daily events are the primary factor in making our investment decisions.

Things like macro data points though, like oil prices or job numbers, they make for interesting news. They can be instructive and we do incorporate them in our investment process and company assessments. Does that make it relevant to long-term wealth? Probably not.

For value investors like us, volatile periods can sometimes present the opportunity to buy a new stock, or add to a position that we really like, for what we believe is an attractive valuation.

Equity Team

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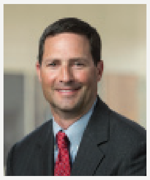

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About RE Advisers Corporation

Founded in 1990, RE Advisers is an SEC-registered investment advisor and serves as investment advisor to seven of the Homestead Funds, as well as the administrator for the entire Homestead Funds family. The portfolio managers of RE Advisers have more than 100 years of collective experience.

About Homestead Funds

Homestead Funds was created in 1990 to give National Rural Electric Cooperative Association (NRECA) members a convenient way to obtain professional and affordable money management. The funds are also open to investors outside of the cooperative community.

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