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Think The Stock Market Is More Volatile Than Ever?

Kate Stalter Contributor

Feeling like markets are more volatile than ever?

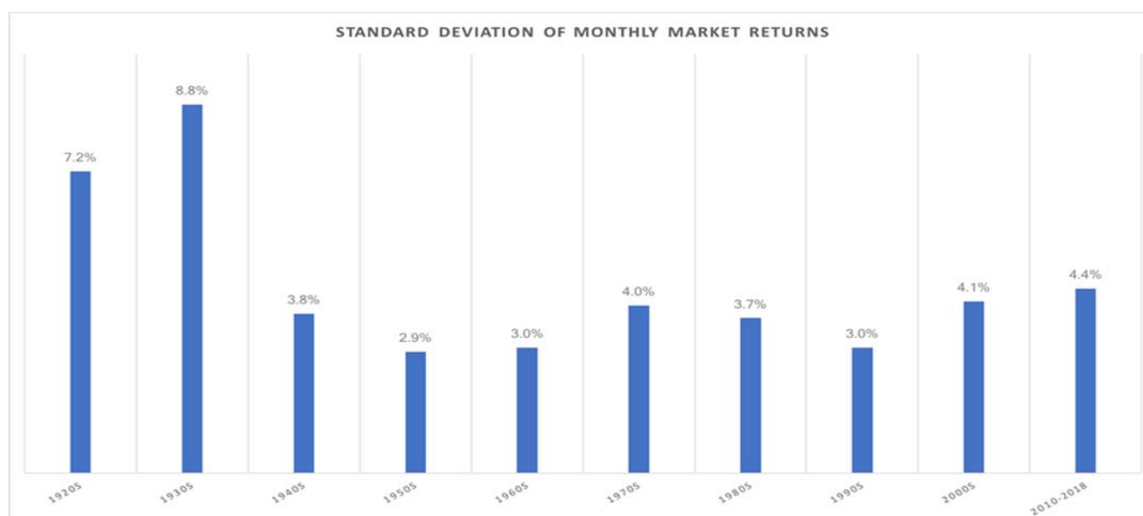
For many investors the stock market swings over the last fourteen months have been scary, and provided fresh reminders of the 2008 meltdown.

In some cases, prices on the Dow moved up 500 points one day and then down 500 the next. It was a very bumpy ride in 2018. The S&P 500 experienced price swings of 2.5% or more eight out of 12 months last year. In December alone, the market lost some 9% of its value and nearly every single day that month, recorded a 1% or greater change between the intraday high and intraday low.

All of this begs the question: When is all of this going to end and what happens if it continues throughout 2019? Has this become the permanent “new normal?”

Stock Market Volatility Is Normal

Statistically, there is a better than even chance that the volatility we experienced over the last year may well continue in 2019, and beyond. The reason for this isn’t because we’re suddenly in new, uncharted territory (although it may feel that way). Instead, it’s because volatility isn’t uncommon. Looking back over several decades it is obvious that monthly market fluctuations of 3% or 4% are not at all uncommon.



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The difference between now and the past is simply that the magnitude of the swings in absolute numbers is larger than they have ever been before. When the Dow was trading at 5,000, back in the mid-1990s, a 300-point swing would have represented a huge 6% move. Today the Dow trades at roughly 26,000, making a 300-point move much closer to 1%. Even if this happens in one day, rather than one month, that level of volatility is still right at historical norms.

So, not only is this level of volatility a normal part of how a liquid market operates, it is also a necessary part of how an efficient market behaves.

Stock Market Volatility Is Necessary

Volatility helps to shake out the short-term players in the market, the speculators who help provide liquidity, but who may not be invested over the course of a market cycle. In other words, volatility is the market's natural mechanism for keeping stock in the strong hands of long-term investors. And history has shown that investors who shrug off short-term volatility in favor of a long-term investment commitment are handsomely rewarded. Turbulent markets also provide another benefit to both short-term players and long-term investors. When times are good – the economy is growing, corporate earnings are increasing quarter-over-quarter, interest rates are low – as they have been for a while now, investors can sometimes get complacent. Believing that good times will continue unabated can cause investors to bid valuations up to the point where they become expensive. This is what former Federal Reserve chairman Alan Greenspan referred to when he coined the phrase "irrational exuberance".

Stock market volatility helps to reign in this exuberance and check investor complacency. Periodic bouts of volatility help to realign valuations so that prices are in sync with underlying corporate fundamentals. Because volatility corrects such mismatches when they exist, it helps keep the long-term health of the market in balance.

What Investors Should Do In Volatile Markets

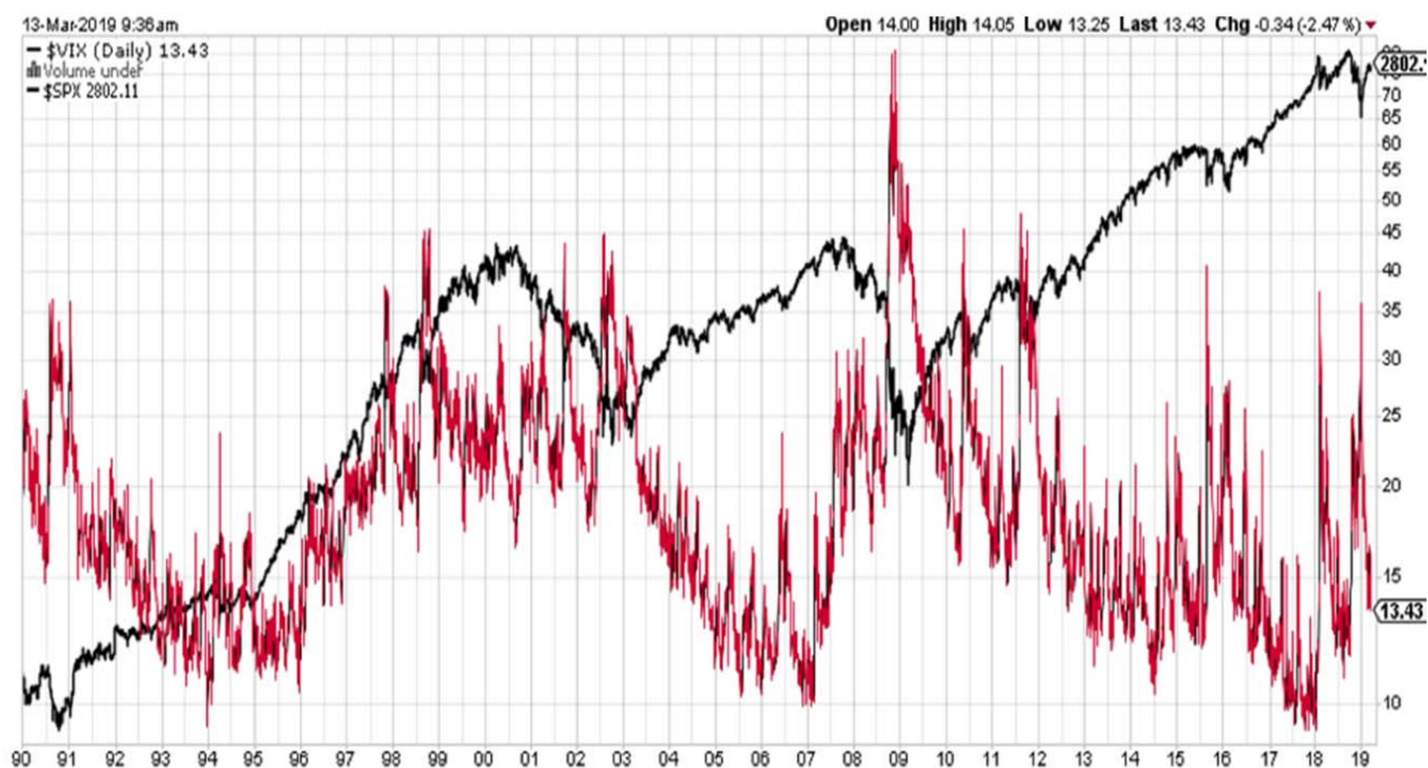
If you consider volatility in the context of the stock market's overall, long-term health, then it isn't difficult to think about it as being a bitter pill, necessary to swallow every now and then in order to stay fit.

And that's the best analogy for long-term investors. Big price swings certainly are uncomfortable. But they are also beneficial in the long run.

So, what should long-term investor do during periods of short-term market volatility?

The most important thing to do is not lose sight of the big picture. Stock-market volatility has certainly been ferocious in the last few years, at least when framed in historical terms. But relative to the long-term trend, two distinct patterns are clearly visible.

The first is that the stock market volatility experienced between the start of 2015 and the end of last month is about on par with where it has consistently been over the last 30 years (see the red line in the chart below). The second, and more important, thing to take into consideration is that in those 30 years, the S&P 500 has increased in value more than seven-fold (see the black line in the chart below).



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So, while stock market volatility can be disconcerting, it really shouldn’t be. This is especially the case for investors with long time horizons. The reason for this is that common stocks have higher expected returns than other, less volatile investments, such as fixed income.

That higher expected rate of return comes at a price, which is higher levels of uncertainty and risk (in the short-term). This is why even long-term investors need to be judicious about their investments.

A Considered Durable Plan Should Beat Volatility

Most individual investors use the stock market as a vehicle for funding their retirement or other future consumption-based goals. As a result, most people have long time horizons over which they can expect their investments to pan out.

That’s why investors would do well to consult with a professional financial advisor for help developing and implementing a long-term holistic financial plan. In the absence of a plan, stock market investments may actually prove to be imprudent. The other danger is that do-it-yourself investors will get spooked by day-to-day volatility and bail out prematurely.

The only way to know for sure is to go through the financial planning process.

But just having a durable plan in place is not enough. That plan needs to be reviewed regularly and adjusted periodically to make sure that it is still on the right track. In addition, investors would be well advised to consider their appetite, or tolerance, for risk.

In the final analysis, an investment portfolio should be constructed to provide the investor with the maximum possible expected return without exposing her to any more risk than she is comfortable.