ALTERNATIVE INVESTING

Once More, Without Feeling

December 19, 2018

I know that, unfortunately, a large fraction of my blogs fall into the category of “viewed properly this isn’t that big a deal.” This one, about this year’s overall U.S. stock market return, is another. Also unfortunate, is how much we need commentary like this (not just mine!). This world is pretty much designed to convince us that we’re always at DEFCON 1, when 5 is the mode and 4.5 the mean.[1] There are some interesting, and perhaps even actually extreme, things going on this year (e.g., breadth of losses across many investments and investment styles). But the overall U.S. stock market is not one of them. However, if you, for instance, watch cable business news too much and absorb the headlines (e.g., “it’s the worst December since the Great Depression!”, “did you see the POINT drop!”) you’d be forgiven for thinking the S&P 500 is on a death march. So, while perhaps repetitive in theme and pedantic, those of us repeatedly pointing out the near constant exaggerations are, I hope, doing something useful.

This post is really simple and short. I’m just going to look at daily returns on the S&P 500 and compare 2018 year-to-date (YTD) to similar length periods over history.[2]

The YTD annualized daily volatility of the S&P 500[3] as of December 17, 2018 is 16.5%. That puts it at the 66th percentile over history going back to 1928.[4] So, sure it’s above median, but if that’s your standard for harrowing, you’ve led a rather sheltered life. It’s 29% of the maximum we’ve ever seen over the same length of time and, to make sure the maximum wasn’t a freak occurrence, it’s 43% of the 95th percentile rolling volatility ever observed. That just ain’t a very big number.

If we look at actual returns,[5] 2018 YTD is at the 24th percentile versus comparable history. Below average, sure, but could you imagine the blaring headline “Freakish year that only happens one quarter of the time!”

Looking at the drawdown (comparing the endpoint of December 17, 2018 to the high point within 2018), it’s at the 22nd percentile. Meaning it’s a worse drawdown than experienced over 78% of the similar length periods (using drawdowns from the peak within 50 week look-back periods here again to make it an apples-to-apples comparison). Again, that’s a mildly bad year versus history. But, again, that’s also nothing to write home about (or, frankly, to write about at all!).

This isn’t exhaustive. There may be some measure or scale that shows 2018 to be truly exceptionally difficult.[6] For instance, as mentioned above, broadening things globally, and to other asset classes like bonds and commodities, and perhaps even to known systematic strategies, likely shows this to be a more surprisingly bad year. Breadth is likely a bigger outlier than depth.[7] Nevertheless, I think many of the breathless (“breadthless” would be at least accurate!) articles and TV headlines you see are indeed essentially about the overall U.S. stock market, and it’s just not that interesting.

So, besides succumbing to the usual media hype, why do so many find U.S. stock markets in 2018 so stressful? Perhaps it’s comparisons to recent times, particularly to 2017. Imagine we did the same exercise as above but, now instead, did it at the end of 2017. Well, the rolling similar length volatility of the S&P 500 on December 31, 2017 was 6.9%. That was indeed extremely low, falling below the 1st percentile of historical experience.[8] So, it’s very possible we may just be comparing today (a slightly more volatile than normal period) to an abnormally calm period (i.e., we’re making a collective error of recency bias or illusion).[9]

Again, on some other scales, and worth further examination, 2018 may truly be more harrowing than what I show here. And none of this is a prediction for 2019. There’s always a chance I’m writing a blog entitled “Well, This is Finally a Big One” sometime next year. But much of the hand wringing and hyperbole over this year’s U.S. stock market returns is just overdone.

Others have written similar posts to this trying to add some perspective to the hype. But, to calibrate our efforts, note that we have collectively (we being the community of people who try to fix such things) failed to get the financial media just to start quoting percentages rather than quoting “points” on price-weighted indices. So, I don’t have a ton of hope that blogs like this one will actually slow down the hyperbole. But I’ll keep trying!

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[1] If, like me, you have to constantly check whether DEFCON 1 or 5 is the bad one, rest assured I just googled it yet again.

[2] This is, obviously, almost, but not quite a rolling year. To keep it apples-to-apples I compare this YTD to rolling similar approximately 23/24ths of a year periods through history. I pull the daily returns for the S&P 500 from Bloomberg.

[3] Calculated using only price return and continuous compounding.

[4] This isn't cherry picked, it's just as far back as the Bloomberg tool in Excel I use loads daily data for the S&P 500. All the results of this short blog look very similar if, instead, I just look at 1990-present. But that doesn't sound as cool.

[5] Again, just continuously compounded price return.

[6] It has certainly been so for many quants, and we suspect for traditional active managers more broadly (in terms of their value-add which is not always total return – that depends on whether it's a benchmark or absolute return oriented investment).

[7] Analyzing this is a much bigger project, with many more choices to make along the way, but perhaps we'll write on this soon.

[8] And please remember there were quite a few over-excited stories worrying about very low volatility. Frankly, it's difficult to conceive of the market that wouldn't elicit over-excited stories.

[9] If we do the same exercise on December 31, 2008 near the bottom of the global financial crisis, we get the rolling most-of-a-year S&P 500 volatility to be 42.7%, that's in the 97th percentile. Both the returns over the rolling period ending then, and the drawdown from the peak over that period, are in the 3rd percentile (the bad ones) and are worse than -40% continuously compounded. So scary events do happen!