



PLIMSOLL MARK CAPITAL

Living with Volatility

There is a common belief that investors fall broadly into two camps; those that want to “sleep well” and those that want to “eat well”. It is assumed for those investors that want to “sleep well”, the avoidance of excess volatility comes with the willingness to forego the potential of higher returns. “Eat well” investors have been viewed as those willing to tolerate higher levels of volatility with an expectation of higher performance.

If in today’s reality it was only that simple. As market volatility rises, there are few remaining places for safe refuge. Not even bonds are the safe haven they were once considered, as their future price volatility will be significant if interest rates rise. **Only cash provides assured stability, but at the current cost of near zero return.**

So we must ask an important question: Is this recent surge in volatility a temporary phenomenon or something more enduring? We will attempt to outline some reasons for the rise in volatility and our belief that investors will be living with volatility for a prolonged period.

We say this because one of the initial reasons for the increased volatility has to do with how the markets themselves actually function. High speed computer trading is responsible for the vast majority of transactions on the stock exchanges. Not only has computer trading profoundly influenced volatility (as in the 1000 point “flash crash” on May 6, 2010), but it has essentially driven the specialist out of the picture. The primary role of the specialist on the floor of the exchange was to provide liquidity, as specialists were expected to maintain an orderly market in their assigned stocks. Today with computer trading so dominant, specialists can no longer risk their capital in the same market making function. Stock exchanges now resemble casinos, with the exchange representing the house. In the process, liquidity has arguably been diminished.

The second reason has to do with a heightened level of fundamental uncertainty. As the debt induced growth bubble of the last era deflates, there is little economic visibility. We have never been here before, at least not in the lifetime of current investors. What will be the headline tomorrow: inflation, deflation, growth, double dip, currency crisis, financial regulation, bank failure, taxes? The list goes on, and all these issues have a meaningful impact on financial markets. With little predictability, markets react violently to changes in perception, and that reaction is amplified by the lack of liquidity. This is an unstable combination, and there is no relief in sight.

What is an investor to do? How do you sleep well, when even a more conservative portfolio is subject to uncomfortable volatility? Fortunately, there is an answer – though it requires commitment and some diligence.

The first step is to recognize that volatility, defined as pronounced short-term price change, may have nothing to do with value. You need to be concerned with the intrinsic fundamental value of an investment because this value is both tangible and reasonably stable. Value provides the grounding and conviction needed to hold an investment through volatile periods.

Investment value comes in various forms. *Traditional valuation* is one form, assuring that you do not over pay for any investment, and *potential growth* is an important factor to consider in assessing valuation. *Income* is another form of value, as income is real and not impacted in any way by price volatility. Finally, the *quality* of an investment is the glue that holds all forms of value together, providing conviction in the value proposition.

The second step is to acknowledge the importance of diversification. While diversification may or may not reduce short-term volatility, diversification will help to assure that risk is spread across various possible fundamental outcomes. Cash, in spite of its low current return, still plays an important role in the diversification equation.

The third and final step is to appreciate the power of time. With a strong sense of investment value and with good diversification, time becomes your friend. Over a minimum three to five year time horizon there is little need to be overly concerned with short-term volatility. (Investments that do not enjoy a three to five year time horizon should not be held in risk assets of any kind). There is a phrase in the investment world: “value will win out.” That means that over the longer term, investments representing good fundamental value, and we are including income in that proposition, will ultimately provide solid returns.

The point of this discussion is to distinguish between price volatility (as reflected in up and down market movements) from the fundamental value of an investment. As investors, we need to concern ourselves with what is tangible and under our control (the value proposition of an investment), and look through what we cannot control, (the investment’s price volatility). The stronger our conviction in the value proposition, the better we can tolerate the volatility.

At Plimsoll, our focus on value begins with the capital appreciation component of the portfolio. This core holding starts with the selection of managers that focus on companies that we refer to as “global franchises”. These companies typically have a global footprint and a diversified business model which will allow them to prosper in an economic environment where growth may be hard to come by. They also maintain strong balance sheets and many pay a dividend. To provide balance in uncertain economic times, there are specific investments that provide protection against deflation (primarily bonds) and positions that should do well when inflation threatens (commodities and gold). And in keeping with the theme *go where the growth is*, we are adding to our holdings in emerging markets when the *price is right*. We have also begun to initiate positions in “alternative strategies” as dictated by client needs. Of course, each client’s portfolio is unique to their own personal situation but each is structured around a common baseline developed by our experienced investment committee.

It may be ironic but the rise in volatility serves to reinforce Plimsoll’s focus on tangible fundamentals as the basic source of investment value. By combining a disciplined focus on investment value with balanced portfolio diversification and patience, we believe investors can “sleep well” and “eat well” while they live with volatility.