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A not so welcome return of volatility

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Volatility is natural in markets

For many investors, a little bit of volatility is a good thing. Security prices move more frequently, creating dislocations that can lead to buying opportunities that they have been waiting for. Price discovery is an important part of the investment process. Some volatility can help shake out stale views and bring new information to security prices. For most investors, a small amount of volatility is acceptable, particularly if it is somewhat range bound and not too extreme. Then there are the volatility traders who long for days of high volatility, preferably in both directions, creating trading opportunities. This is a small group who have largely been sidelined for much of the last year or longer as the markets had relatively low volatility and largely moved in one direction - up. As you might expect, this group has been back on the field in a big way this week as coronavirus fears have shaken markets to their core. Since February 20, 2020, U.S. equity markets are down close to 15%, the fastest decline towards bear market territory in history[1]. The results overseas are similarly down but not as much as in the U.S. at this point. This is likely due to the elevated valuations of U.S. stocks entering the week among other factors. U.S. Treasuries have rallied through prior record lows, reflecting the flight to safety expected during periods of high volatility and uncertainty.

Potential implications to volatility

So what does this all mean for Harbor products, our Subadvisory partners and our investors? Harbor offers a range of different investment strategies, some that have been hurt by this sell-off more than others, reflecting the diversity of approach and style that exists in our product line-up. A number of Harbor's products, including the recently launched Harbor Robeco Conservative Equity funds, are expected to perform better than their more equity beta – a measure of systematic risk, or the sensitivity of a fund to movements in the benchmark – biased peers. Other strategies will likely lag for a period while our Subadvisory partners incorporate the new information in their research processes. We have observed how some of our older products have performed well coming out of prior high volatility periods and expect similar results to come through eventually. This is not an easy environment for any investor, but we believe our Subadvisory partners are highly capable and will make informed decisions across their portfolios. Some will likely stand pat and ride out the volatility, making few if any moves unless the long-term fundamentals and investment thesis supporting a holding have truly changed. Others will be a bit more tactical, seizing on opportunities that arise to add value to the portfolios now and into the future. These types of environments, while very challenging, can be very rewarding for active managers.

[1]Wall Street Journal, Feb 2020

Comfortable with the uncomfortable

Right now there are many, many questions and any answers are speculative and uncertain. Dozens of investment firms, bankers and economists have all weighed in on how significant the impact of a global economic contagion from a pandemic may be, but no one truly knows what the outcome will be or when markets will settle down. Past examples all occurred in different eras. The current global economy is much more interdependent, whether that is in global supply chains or global consumption patterns. If there is one known against a longer list of unknowns, it is this – the national economies of most countries are cogs within the global economy and when one or more cogs has an issue, the impact is felt globally. As uncertainty grows about the spread of the coronavirus and the responses of each nation affected or expected to be affected, more cogs will become impacted. With greater uncertainty comes more unknowns, which markets do not like. This has contributed to the higher volatility, growing concerns about future economic growth and the flight to safety we have observed this week. Right now, due to the interconnected nature of the global economy many of the cogs in the global machine are showing signs of seizing up, which eventually impacts the entire machine. But economies, countries and people are resilient and will likely find ways to fix the machine, though this may take time and patience.

In time, there should be signs of a new normal

Past history, to the extent it is relevant in this case, would indicate that eventually the markets will settle down as some of the unknowns become better known and investors start to have greater clarity on actual versus predicted outcomes. In prior instances of turmoil, the markets recovered from the selloffs and began to reflect the future expectations for growth post the event. In our view, that will likely be the case here, but there are so many unknowns at this point that trying to predict when the bottoming will occur is impossible. This week's volatility and sharp declines may continue into the next week and next quarter as news spreads about more people in different countries becoming infected. When the current downward trajectory will stop, and equity markets begin to bottom, remains unknown. In times such as these, adherence to investment principals of diversification and long investing time horizons may be challenged. However, if past history repeats, staying the course and maintaining a focus on the long-term goals of investment plans will likely allow investors to eventually recover and return to growth. This may take time, patience, and fortitude when all signals point to getting out, but in my investment experience, few investors are capable of making two correct decisions in these types of environments. Those that think they can time the recovery have to correctly time their exit and more importantly when to re-enter the market at the bottom. This timing of the market is very hard to do. Early Q1 2009 saw many investors throw in the towel to avoid more painful declines only to miss the market turn in March 2009. Staying focused on the long-term can help investors fight against behavioral biases that tend to cause poor decisions.

Be patient, stay invested, and focus on the long-term

In summary, we have no greater clarity than anyone else on how this period of volatility and uncertainty will play out. We do believe we have a talented group of Subadvisory partners who will make prudent investment decisions that reflect their best thinking on how to manage through this. As in line with our daily operations, Harbor will continue to monitor those decisions to ensure the best interests of our clients and investors are met. It may continue to be challenging for days or weeks, but eventually companies will figure out how to operate within the changing global economy in ways that will continue to seek to deliver value to shareholders over time.

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