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PERSPECTIVES

VIEWPOINTS FROM THE ACADIAN TEAM

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"VOLATILITY IS NOISE": A CONVENIENT MYTH

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In early February, equity markets were jolted out of a protracted period of historically low volatility. Among commentators, one prominent response to the sudden shift in market conditions has been that investors ought to "look through" the gyrations. While in some cases, that reaction reflects a sanguine view on stocks based on economic and fundamental strength, we've also seen the re-emergence of a notion that for long-term sophisticated investors, market volatility is "meaningless" or "noise."

The popular narrative that volatility doesn't represent risk is oversimplified and misleading. It's a convenient selling point to private market investors, who may not realize that they are exposed to the variability in asset prices that is evident in open public markets. If reported private market returns better reflect economic risk, then the higher apparent volatility of public markets would seem unnecessary.

But we should expect the volatility exhibited in public markets to be a relevant and meaningful indicator of economic risk. For one, it is a byproduct of the powerful public market clearing mechanism. Price discovery reflects composite views of all market participants, transmitted through constant buying and selling. Volatility represents the continuous aggregation and re-evaluation of an enormous volume of information regarding fundamentals, the economy, and risk appetite. Contrast this with a private asset that does not trade and has its value set infrequently by an owner who is far from arm's length.

Of course, as Robert Shiller and other academics have argued, public markets are more volatile than we'd expect based on fundamentals. But price variation generated by uninformed trading and animal spirits also represents real risk, even to sophisticated, long-term investors. While noise trading no doubt generates volatility that has a reverting character, it may take considerable periods, perhaps years or a generation, to correct some deviations from fundamentals. Further, as we observed in the GFC and the internet bubble, among a host of other past episodes, investors' behavioral errors apparently can fuel such large pricing dislocations as to create first order systemic risk for asset values, broadly speaking. Less transparent markets (e.g., real estate) may even have greater exposure to such problems.

And as a practical matter, *in the moment*, it is very difficult to distinguish between "normal volatility" and "incipient permanent loss" (or gain). Was market volatility prior to Lehman's collapse "noise?" At what moment should an investor have been able to distinguish a "typical correction" from the advent of a potentially unrecoverable generational crisis? Once severe losses had occurred, when should an investor have been able to recognize that the U.S. market wouldn't suffer a 25+ year slump like Japan following its late-1980s implosion?

Notwithstanding academic discussions about market efficiency and excess volatility, the recurrent narrative that public market volatility is noise is perpetuated, in part, by simple semantics. Volatility is often described as "short-term," "interim," or "price fluctuations." But these modifiers and synonyms, although seemingly innocuous, profoundly alter the meaning of the word. They inject it with ex-post knowledge, implying that volatility represents price movements that *we know in advance* will be reversed.

When described in such terms, the premise that volatility isn't relevant to long-term investors becomes nearly irrefutable—but also empty. If we knew that price movements would be temporary, then we could easily shut our eyes when an inherently temporary "spate" of volatility occurs and wait for it to die down and prices to "revert." Of course, if we had such foresight, then we could also exploit the inherently transient price fluctuations; we should easily make a fortune day trading stocks and market timing.

Nevertheless, the volatility-as-noise thesis would still have meaningful implications if we had confidence in our ability to foresee the long-term trend, even if markets aren't easily predictable in the short-run. But ability to predict market returns over long horizons is much easier to assert than to substantiate. There is vigorous debate, not consensus, over long-term expected returns, and the range of relevant issues, conceptual and empirical, is enormously broad (e.g., demographics, technology, post-QE monetary policy). As well, we know little about how markets actually "set" long-term expectations. As Shiller discussed in his 2013 Nobel Prize Lecture, investors may well fixate on some conventional, perhaps arbitrary, valuation perspective. If incorrect, it may require gradual accumulation of enormous counterevidence, and possibly generational change, to shift beliefs.

But particularly in recent years, a sense of long-term predictability has become difficult for investors to resist. The post-GFC market experience has dulled the painful truth that not all assets that go down come back up. Risk assets, especially leveraged risk assets, have benefitted from an environment in which governments have backstopped asset values and poured liquidity into markets. As a result, investors who have bought on dips have been repeatedly rewarded, and investors who have not have faced potentially significant underperformance. More insidious, investors holding assets whose volatility has been masked by infrequent, smoothed, and discretionary valuations, may not have a true sense of their economic risk.

If the next decade doesn't look like the last, those whose invest based on the premise that volatility is noise may be forced to confront greater risk to long-term and non-public investments than they had anticipated.

BIOGRAPHY

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Seth joined Acadian in 2014 where he currently heads Client Advisory, aligned closely with both Acadian's Global Client Group and Investment Team. Before joining Acadian, Seth was a managing director in Equity Derivatives Trading at UBS. Previously he was a researcher at Barclays Global Investors, focusing on options and volatility, and he helped to establish and later ran Deutsche Bank's award-winning Equity Derivatives Strategy Group. Seth holds a Ph.D. in economics from Stanford University and a B.A. in economics from the University of Chicago.

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