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MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Market Evolution:The Only Constant is Change

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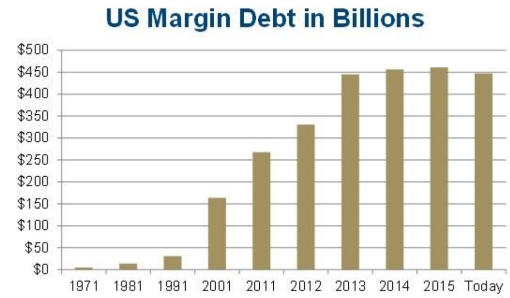
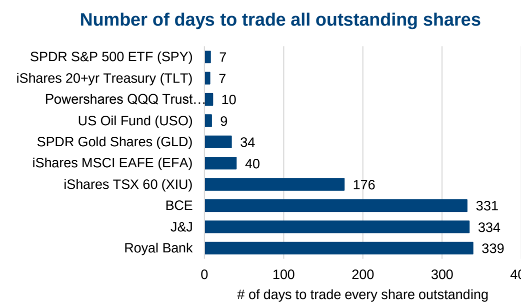
The market is an ecosystem, a community with many participants interacting with each other and the environment itself. And with any ecosystem, it evolves over time often the result of the behaviour of its participants. If you doubt this, just look at how investor behaviour has changed over the years. For NY Stock Exchange listing, the average holding period today is slightly over two years. However, in the 1930s to late 1970s it was over ten years. Today's average time horizon or holding period is actually more similar to the early 1900s (top chart). The amount of margin has changed from almost none in the 1970s to about ½ trillion today (middle chart).

More than half the volume on the exchanges is driven by computerized trading. That is a far cry from when humans sat in the pits and traded by talking to one another. Oh and there are literally dozens of exchanges today compared to a couple in decades past. The speed at which investors move around asset classes and stocks is a new pheromone in the market and it does change the behaviour of other participants. The SPDR ETF, the world's largest ETF, has already traded 25 million shares in the first hour of trading today and every seven days its volume totals all the shares outstanding. In contrast, BCE takes 331 days of trading to total its total shares outstanding (bottom chart). These numbers are clearly different than the 1960s when holding periods were measured in years, not days.

Markets evolve and the behaviour of participants changes. Understanding the source of changing behaviours, its impact on markets and how to navigate successfully have become paramount for long term success. In the next couple of pages we will highlight some of these changes and what it means for portfolio construction.





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Bigger Swings

The rise of ETFs have allowed investors to speculate much more than before. Think about it, to gain exposure to the S&P 500 you used to have to buy 500 stocks or a large number as a proxy. Now you can do this with one trade. This ease of access has certainly contributed to more manic investor behaviour. The top chart is monthly flows into equity funds and equity ETFs in the U.S. over the last eight years. Notice how the fund flows ebb and flow, sometimes in net redemption for a year, sometimes in net contribution for a year. The ETF flows on the other hand are bigger and often reverse from one month to the next. And yet, the asset base for mutual funds is 7x that of equity ETFs, again pointing to ETF investors as more speculators or shorter term investors compared to funds. This has undoubtedly attributed the increased volatility in the markets.

Compounding the impact to volatility of increased turnover has been an increasing use of leverage. Nearly half a trillion USD in margin debt is in play on a daily basis, exaggerating the impact of swift selloffs that can cause margin calls, which only put more downward pressure on a stock.

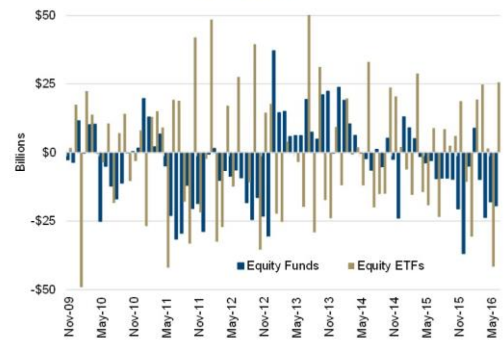
Be Tactical - We believe investors should expect bigger market swings. Strategies to help mitigate these swings should be considered. Also strategies to take advantage of market overreactions could also help long term performance.

Diversification Benefits

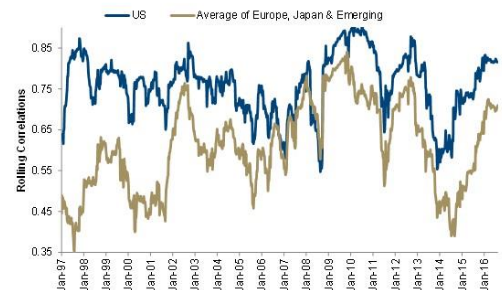
Everyone likes to talk about diversification. However, with the market evolution towards greater globalization and interconnectivity certain types of diversification have diminished from a risk reduction perspective. Correlations among equity markets around the globe have steadily risen (2nd chart). This limits the risk reduction historically enjoyed from diversifying internationally. There are still benefits from going more international from a return perspective, but the risk benefit is muted.

Even correlations between individual equities is lower than normal. The bottom chart measures stock disparity, or how individual stock performance is dispersed around the overall index. When this is low, the benefits of diversification within an index is limited. It has been getting better, but is still below the historical average.

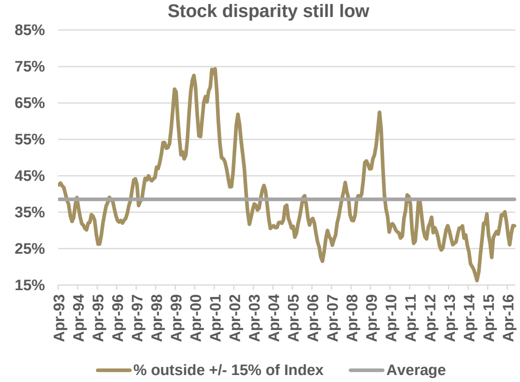
ETF flows demonstrate manic investor behaviour



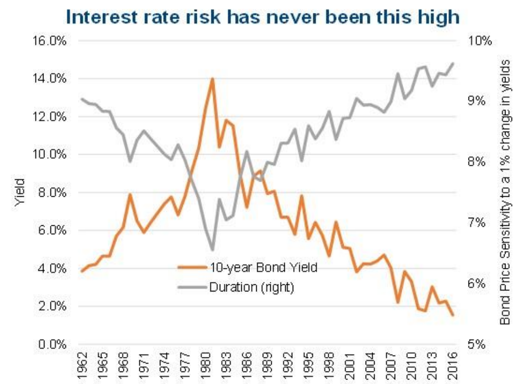
Market correlations are elevated, diminishing the risk benefits of international diversification

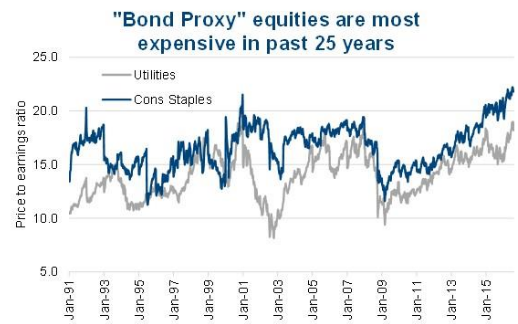


Stock disparity still low



Traditional diversification has become harder to come by and investors may want to explore different strategies to help diversify their portfolios.





Monetary Experimentation

In many schools around the world there are folks adding a section to economic textbooks covering negative interest rates. Naturally this can be found after other new sections on excessive quantitative easing. Of course the hard part for the authors will be to write the conclusion. Did it help? Did it create bubble or unintended consequences? Time will tell.

These forces, coupled with demographics, too many savers to borrowers, have forced investors to chase yield out the curve extending the duration and/or credit risk in their portfolios. The average duration (the sensitivity to a 1% chance in interest rates) has never been as high as it is today. This has increased risk in many parts of the bond market.

This pursuit of yield has spilled over into the equity market with investors bidding up bond proxies like Consumer Staple and Utility stocks to record highs and record valuations (2nd chart). These stocks tend to be seen as bond proxies because of their yields supported by consistent and defensive cash flows. Valuations in these sectors are at the highest level in 25 years, leaving them very susceptible to a retracement if yields were to rise.

These markets have evolved and risk reduction has become harder to come by. Perhaps this is partly due to defense being the 'in vogue' strategy for the past number of years given market volatility and memories of 2008. The problem is many of these defensive strategies have become much less defensive than they used to be and some even risky. As markets evolve, sticking with the same strategy can become a detriment and at the very least the basis should be tested on occasion.

Charts are sourced to Bloomberg unless otherwise noted.