HIGHVISTA STRATEGIES

A Tale of Two Months

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The fourth quarter of 2018 was an extremely difficult period in the markets. A confluence of issues—including concerns about decelerating economic growth, Federal Reserve policies and political gridlock—significantly impacted investor sentiment. U.S. equities were down 14.3% and smaller capitalization stocks declined 20.2%. Non-U.S. equities fared only somewhat better, and oil was down 38%. The quarter had many “worsts,” including the worst December in U.S. equities since 1931.

The market carnage in 2018 occurred primarily in October and December. As long-term investors, we usually do not glean much from results in any one or two months, but this period was quite unusual and instructive: there were similarly sized declines in global equities and other important markets, yet our risk-based approach to asset allocation held up much better in December than in October

Our strategy is to seek to protect capital through several essential means. Critically, we invest the bulk of the capital actively—through managers as well as directly—where the primary focus is bottom-up security selection that is fundamentally based and emphasizes a margin of safety. In doing so, we maintain diverse sources of value-add within our manager and direct active portfolios. We also utilize a top-down lens to assess the portfolio’s macro exposures: the goal being to manage for global diversification and to manage overall portfolio risk. We do so by proactively and systematically quantifying market risks and adapting portfolio exposures as conditions become more or less benign. Together, these approaches are also synergistic. The best opportunities often are to be found in turbulent markets and in a bottom-up fashion. But one needs to be able to deploy capital at those moments and dynamic hedging helps to provide dry powder and staying power in such environments.

October was characterized by an equity market downdraft that came with little warning. As one of our clients put it, “it’s like you were bitten by a rattle snake that didn’t rattle.” We were fully invested because our risk gauges, including the VIX, were low going into the month, reflecting the then period of extended market calm. By contrast, December’s decline was preceded by the elevated volatility in October-November, and as such we entered the month with lower equity exposures.

The October market decline was a head scratcher given the absence of fresh bad news. The headlines included a report of excess production of oil, continued concern about the U.S.-China trade war and speculation about the extent of a Democrat victory in the November election. None of these headlines, however, really explained the magnitude and speed of the decline. December’s decline, by contrast, made somewhat more sense, particularly given the Fed’s decision—which it has since reversed—to maintain its hawkish stance in the face of slowing U.S. and world economic growth (and possibly to defend its independence in face of jawboning by President Trump.)

While we are fully aware that calm markets followed by a decline of October's speed and magnitude are possible, such events are highly unusual. Since 1990, when the VIX was first published, there have been 34 distinct periods in which global equities declined by 7% or more over a span of 30 days. In only two of those instances was the going-in VIX as low as that prevailing in late September. They occurred in May 2006 and August 2015: in both cases global equities were down approximately 10%, but in those periods other components of our strategy fared better. The worst 30-day market decline since 1990 was -35% in Sept/Oct 2008, for which our hedging approach was well prepared given that volatility metrics were very elevated.

Volatility-based hedging over the years has not always been beneficial, but it has a strong track record of reducing exposure to tail risks. Focused on protecting capital while keeping the portfolio fully invested in more tranquil conditions, this approach has added to return more than it has subtracted. At its core, we are relying on compelling evidence and logic that the riskiest periods in the market and the world are far more likely to be preceded by elevated volatility than calm conditions.

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