

VOLATILITY IN PERSPECTIVE

By Ed Easterling

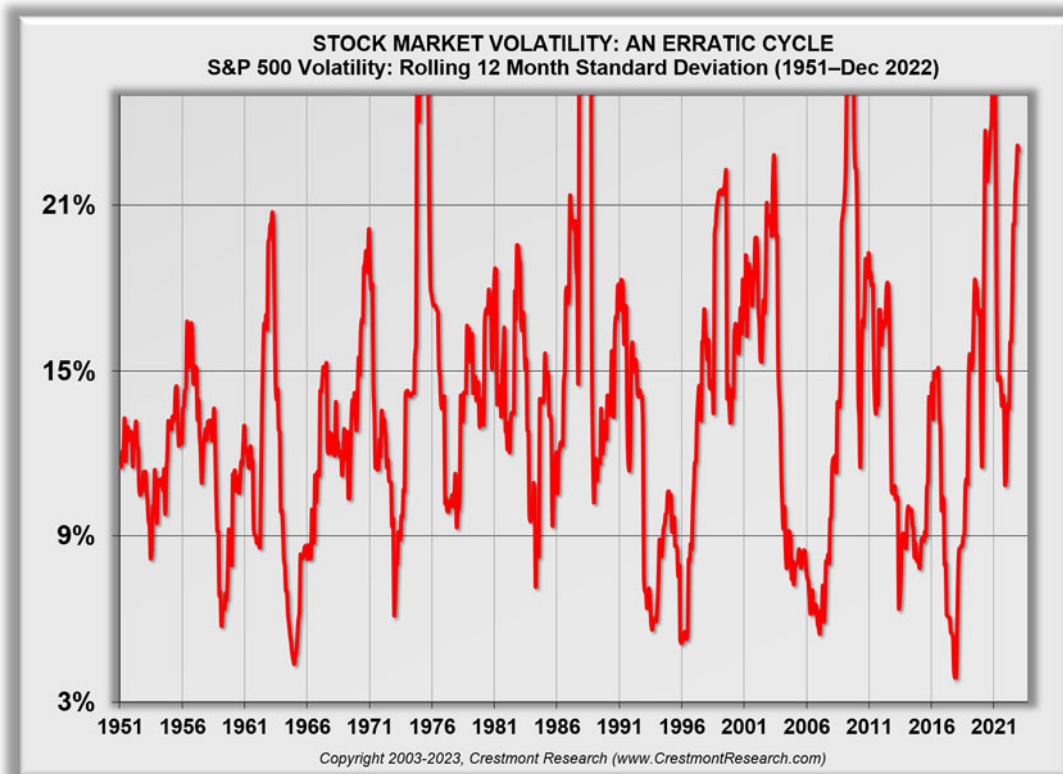
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Is the current level of volatility “normal”? If so, it’s a new normal! The purpose of this presentation is to graphically put volatility into historical perspective. This report will be updated periodically as volatility itself is just too volatile to be ignored.

The first look at volatility uses a common measure known as standard deviation. For this analysis, the monthly percentage changes in the S&P 500 Index are used, and then the result is annualized to measure of the amount of variability in the market. This statistic is often used by financial market professionals as an indication or measure of risk in models that assess risk versus return. It’s not essential for this discussion to go into detail about the statistic—it is only necessary to appreciate that it is one of the most common measures of volatility and to recognize that a higher value means higher volatility.

Figure 1. S&P 500 Index Volatility: Rolling Volatility (1950 to Present)



Let’s look at seven decades of volatility...to put volatility into perspective. To understand volatility and its change over time, Figure 1 presents the twelve-month rolling standard deviation for the S&P 500 Index. The concept of rolling periods just means that the value that is used for each month is the standard deviation (a statistical measure of variability)

for the most recent twelve months. So as the market goes through periods with big monthly changes or calm stability, the measure reflects those changes.

As you can see in Figure 1, volatility tends to average near 15% (the average that many models and academics use for stock market volatility). Yet one of the most interesting aspects of the history of volatility is that it tends to move around a lot. Although most periods generally fall within a band of 10% to 20% volatility, there have been periods when volatility was unusually high and periods when it was unusually low...and often extreme periods in one direction are followed by oppositely extreme periods. The time between the light grey vertical bars on the graph represents five-year periods. Thus, some of the extreme periods can last for a while, yet few last a long time.

For most of the mid-2000s, volatility had been unusually low—and by late 2006 and early 2007, volatility fell into the lowest three percent of all periods since 1950. No wonder that investors and market spectators had become complacent to market volatility...or maybe complacency about risk led to the low volatility. Nonetheless, the waters of the market were unusually calm.

Then, in 2008, volatility surged to startling and anxiety-producing levels. This longer-term measure (which is a little slow to react since it includes twelve months of information) increased to more than 25%—relatively high by historical standards, yet not without precedent. Soon after, volatility settled back within the typical range—the midrange that acts as a holding pattern until volatility again breaks in either direction.

Across most of 2013 and 2014, an eerie calm returned to the stock market. Volatility plunged to near 2006/2007 levels. As history has shown, another surge to higher volatility was not far away. As 2015 progressed, volatility rose—albeit only to levels near average. The market's rallies over the subsequent two years tamped down volatility, to a record low for volatility in November 2017. That was the proverbial calm before the storm. In late 2018, sharp market declines significantly surged volatility. By early 2019, the uptrend subsided, and volatility mellowed as the market rallied. Few expected the dramatic surge in volatility during 2020, first because of Covid-driven market declines and then despite an unexpected market rally. During recent years, the market and volatility gyrated inversely, yet volatility mostly remained elevated.

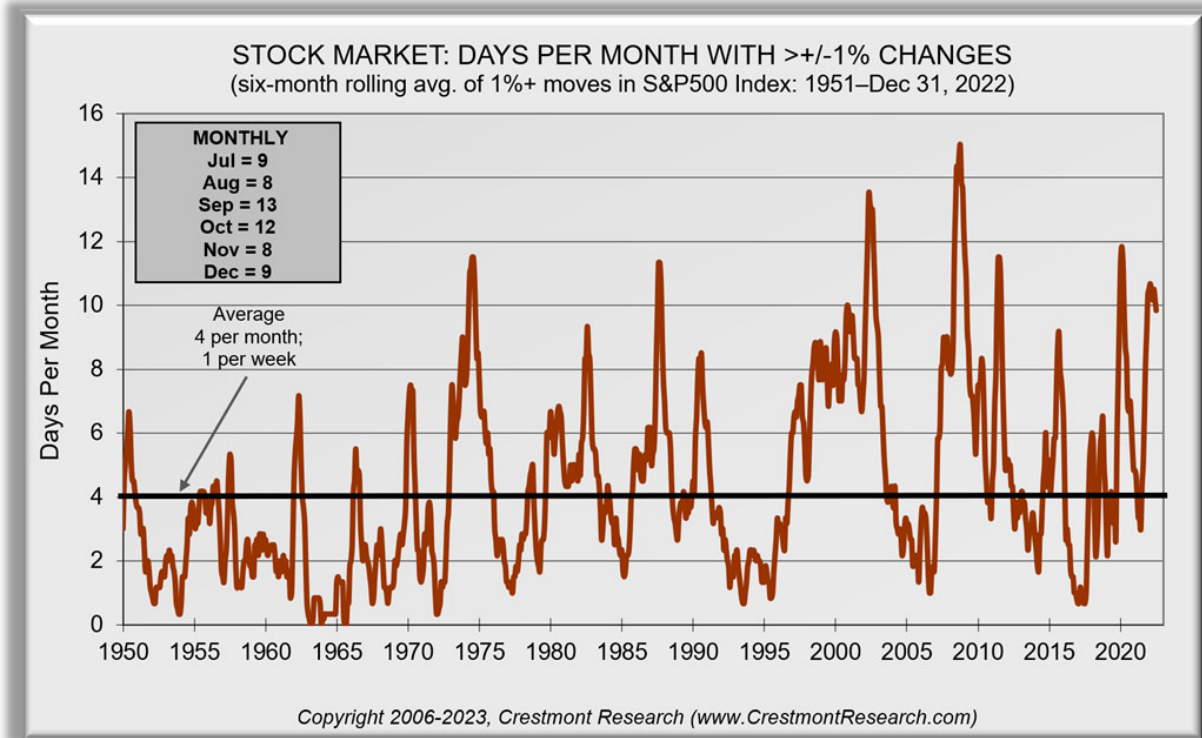
For further insights about near-term changes and trends in volatility, we can look at two other measures: (1) the frequency of days each month when the stock market index increases or decreases by more than 1% and (2) the intra-day range expressed as a percentage. The first of these measures reflects the “six o'clock news summary” of daily volatility—since significant moves in the market often make the news—and the second reflects the “rollercoaster” that many professionals experience. For example, there are days when the market opens higher or lower and stays there—so measuring 1% days reflects the magnitude of daily changes. Therefore, with only a week or month of trading days, we can quickly see emerging changes in the overall level of volatility.

On other days, when the market professionals get home with that worn-out-look, the market may have swung wildly yet closed with little change from the previous day. Therefore, to capture that aspect of volatility, we can measure the difference between the high and low price each day and present the range as a percentage of the previous closing price. A higher percentage reflects higher volatility.

First, let's look at the frequency of days each month that the market index changed by 1% or more. At times in the past, some months reflected one day or none with 1% days. At other times, the market moved by one percent virtually every other day. Keep in mind that most months have about 21 trading days.

As reflected in Figure 2, the historical average going back more than seven decades reflects approximately four "1% days" per month...thus about one per week. In the mid-2000s, it was common for volatility to be less than half of the average. Yet, as recently as 2002, there were times when "1% days" occurred more often than every other day. In June 2007, the tremors started and awakened the market. The subsequent two years or so, although somewhat erratic, were enough to drive the measure in the graph—the six-month moving average—well into above-average territory. Then over several years, volatility calmed a bit—only to surge again in 2011. By the end of 2013, and continuing into 2015, volatility returned to below-average levels. Yet, as reflected in Figure 1, the "1% days" measure of volatility rose through most of 2015 and then settled down significantly across the subsequent two years. As with the previous measure of volatility, this measure surged as well during late 2018, settled down by late 2019, and again surged in 2020. This measure also has been mostly elevated over recent years.

Figure 2. S&P 500 Index Volatility: 1% Days (1950 to Present)



Next, let's look at the other shorter-term measure of volatility trends and changes: the average daily range. This one could be called the "rollercoaster factor" since it measures the trough-to-peak each day as a percent of the market index. For example, if the S&P 500 Index starts at 1015 and falls to 1000 before ending at 1014, the daily range was 15 points (i.e., 1015 minus 1000) or 1.5% (i.e., 15 divided by 1000). The intra-day information that is needed for this measure is available from 1962, providing over four decades of

data. The average daily swing over more than forty years has been approximately 1.3%. At today's levels, that's about 50 points for the S&P 500 Index and the equivalent for the Dow Jones Industrial Average would be almost 450 points.

Figure 3 reflects that the average daily range has been similarly variable like the other measures of volatility. It is the most quickly reacting measure of volatility. Average Daily Range rose across much of 2015, then settled back a bit. That trend continued through the subsequent two years, ultimately reaching near historic lows. As with the others, this measure of volatility surged in late 2018, calmed in 2019, surged again in 2020, and calmed again in 2021 before surging in 2022. Volatility is volatile!

Figure 3. S&P 500 Index Volatility: Daily Range (1962 to Present)

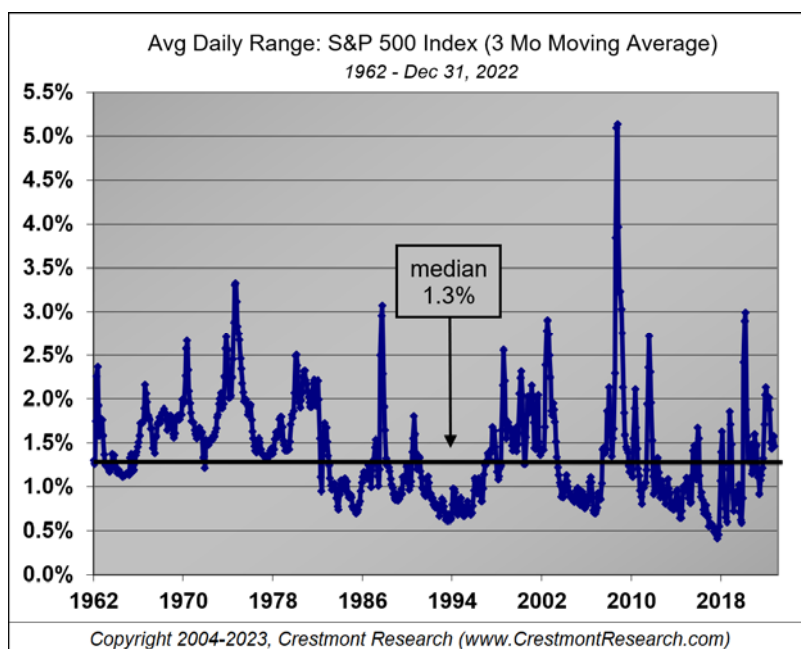


Figure 4. S&P 500 Index Volatility: Relationship To Market Returns

Relationship Of Volatility & Market Returns (S&P 500 Index: 1962–Dec 31, 2022)						
MONTHLY DATA: S&P 500 INDEX AVERAGE DAILY RANGE						
Quartile	Volatility Range	% Chance Up Month	% Chance Dn Month	If Up Avg Gain	If Down Avg Loss	Expected Gain/(Loss)
1st	0% - 0.9%	78%	22%	2.7%	-1.5%	1.8%
2nd	0.9% - 1.3%	63%	37%	3.1%	-2.3%	1.2%
3rd	1.3% - 1.7%	55%	45%	3.2%	-3.2%	0.3%
4th	1.7% - 6.6%	43%	57%	5.0%	-5.0%	-0.7%
ANNUAL DATA (1962–2022): S&P 500 INDEX AVERAGE DAILY RANGE						
Quartile	Volatility Range	% Chance Up Year	% Chance Dn Year	If Up Avg Gain	If Down Avg Loss	Expected Gain/(Loss)
1st	0% - 1.0%	93%	7%	16.1%	-1.5%	14.9%
2nd	1.0% - 1.4%	73%	27%	16.0%	-6.3%	10.1%
3rd	1.4% - 1.7%	87%	13%	17.4%	-5.9%	14.3%
4th	1.7% - 2.7%	38%	63%	15.1%	-18.6%	-6.0%

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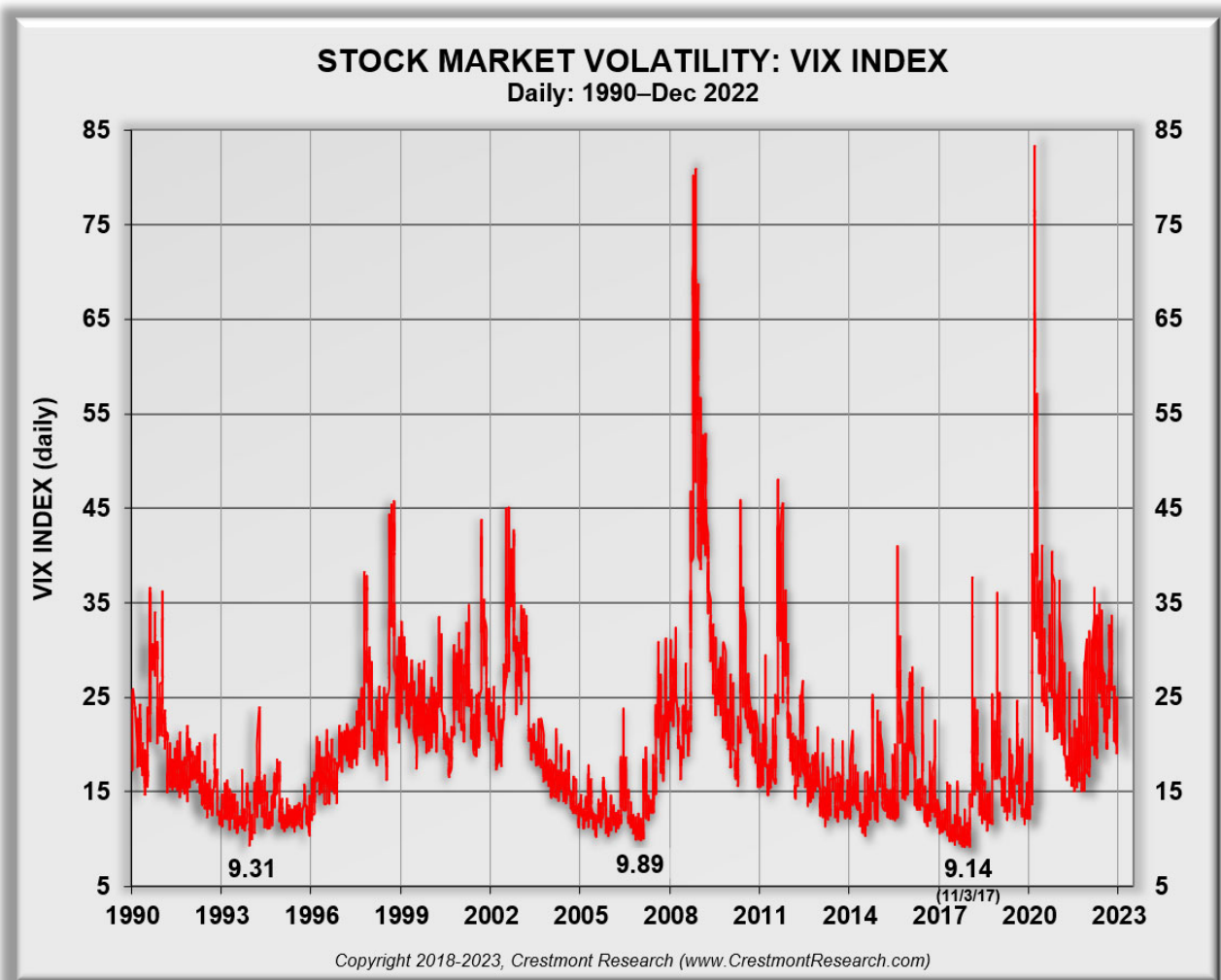
In Figure 4, as an update to the information initially presented on page 48 of *Unexpected Returns* and discussed in the book, the table reflects the propensity for the stock market to perform well in lower volatility periods and perform poorly in higher volatility periods. The principles of valuation and volatility that are explored in *Unexpected Returns* are the key drivers of stock market returns and performance over multi-year periods.

VOLATILITY'S VIXEN

The VIX Index is a forward-looking measure of market volatility. VIX reflects the relative level of option premiums (or prices); it's a measure of *expected* future volatility in the market. The index was created in 1990. Prior to 2017 (almost 7,000 trading days), VIX closed below the ultra-low level of 10 on just nine days.

During 2017, VIX anchored below 10 on 52 days. Further, as shown in Figure 5, VIX struck a new low in 2017 at 9.14. In January 2018, VIX added seven single-digit days (cumulative total of 68) and has not been there since. VIX represents another measure of volatility that confirms the high degree of variability in the level of market volatility.

Figure 5. VIX Index History: 1990 Inception to Date



CONCLUSION

From ultra-low levels of volatility to ultra-high levels and back again, the recent decades have been unique—but not unprecedented. There are several ways to measure volatility, some with longer-term, bigger-picture perspective. Others provide a shorter-term, more current view of conditions. All measures currently reflect that volatility has surged off recent extreme historical lows.

A historical perspective of volatility reflects that higher volatility periods are normal and they can extend for quarters or years. Many investors anchored on the extreme low volatility years during the mid-2000s and came to expect low volatility as a normal condition. They were surprised by the subsequent period of high volatility. And now, market volatility has again shown that it doesn't remain at the same level for long. Average is an uncommon level for volatility.

An understanding of history provides a more rational perspective that can help investors take action to protect their portfolios during rising or high volatility periods, while positioning to participate in improved market conditions as volatility later abates.

High or rising volatility often corresponds to declining markets; low or falling volatility is associated with good markets. Periods of low volatility are reflections of a good market, *not a predictor of good markets in the future*. The recent surge in volatility is a good reminder to assess portfolios for their ability to weather market storms.

Ed Easterling is the founder and president of Crestmont Research. He is the author of award-winning Unexpected Returns: Understanding Secular Stock Market Cycles and Probable Outcomes: Secular Stock Market Insights. In addition, he previously served as an adjunct professor and taught a course on alternative investments and financial markets for MBA students at SMU in Dallas, Texas. Mr. Easterling publishes provocative research and graphical analyses on the financial markets at www.CrestmontResearch.com.