NEWSLETTER
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Edgeworth Partners

Introduction

This month, we have an in-depth look at market volatility. It is something you hear about all the time, but not something people truly understand. We show you that market volatility is often associated with negative price changes - and discuss how you can benefit from this knowledge.

Famous People in Finance – The Tang Dynasty

Here is one for your next trivia night: who invented paper money?

The answer is that paper money was invented during the Tang Dynasty in China during the seventh eighth and ninth centuries. Prior to paper money, the Chinese (like many other cultures) used coins to facilitate exchange. Over time, people started to leave their coins with a trusted person who gave them a piece of paper recording how many coins they had ‘deposited.’ These pieces of paper soon came to be exchanged in their own right - and paper money was born.

In many ways it makes sense that the Chinese gave us paper money, given that they also invented paper and printing!

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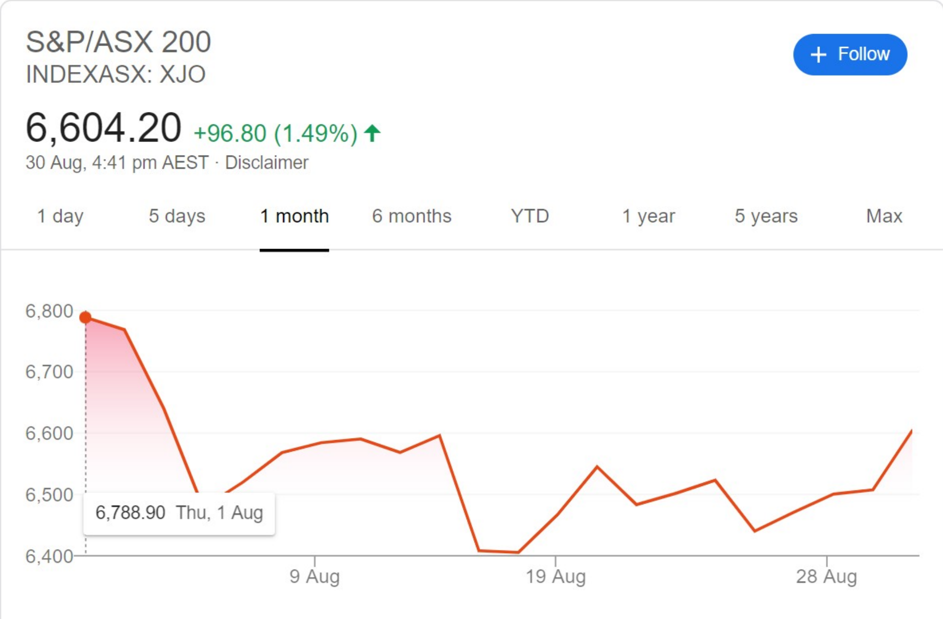
The Share Market

August was a volatile month on the Australian Share Market. The volatility can be seen in the following graph, sourced from Google and the ASX:



Never ones to look a gift horse in the mouth, we reproduce graphs from Google and the ASX each month when we do our market report. In the graph above, you can see that red is the colour of the graph line. This indicates that the market fell across the entire period shown on the graph (in this case, the entire month of August). You can also see that the closing level of the S&P/ASX 200 index was 6604.20 points. Just next to that figure is a smaller figure in green. This figure is +96.80. This refers to movement in the index on 30 August - the last day of trading for the month of August. The figure in brackets (1.49%) shows what an increase of 96.80 points represents into centage terms.

So, the graph tells us that the market rose by almost 1.5% on the last trading day of the month.

Across the entire month, the market fell by 2.7% from its opening at 6788.90 points on 1 August. Obviously, this fall would have been more substantial had the market not risen so substantially at the very end of the month. On 18 August, the market bottomed out (for the month) at only slightly above 6400 points - a fall of 5.7% from the first day of the month.

The graph also shows that large single day movements in prices were common in August. The market's rise on August 30 was not the biggest single day movement for the month - although it was the biggest single day rise in prices. So, August was notable not only for the fact that the market fell by 2.7% from the start of the month to the end of the month, but also for the fact that the month included a series of very sharp price changes. Put simply, it was a volatile month.

The term volatility is an interesting one for investors. Volatility does not simply mean changes in prices. Rather, volatility means that prices are changing in different directions and by significant amounts. Interestingly, as well is the index represented above, which tracks changes in market prices of the largest 200 companies with shares trading on the ASX, S&P/ASX also provide a volatility index – known as the VIX. However, the VIX is a little different to the ASX 200 index, in that the VIX measures expectations of market volatility, rather than levels of volatility that have actually been observed. The VIX measures what people think will happen rathr than what has actually happened.

The VIX tends to have the same effect as a measure of what has already happened, however, as most people's expectation of near-term volatility (that is, volatility in the immediate future – 30 days, in the case of the VIX) will be based on their observation of very recent volatility. That is, if the market has recently been volatile, people expect this to continue. If the market has been relatively calm, people expect that to continue as well.

We have reproduced below (again, thanks to Google on the ASX) S&P/ASX's volatility index for the month of August 2019. Please take care when you look at this graph. The green line is a little bit misleading. For the basic sharemarket graph, a green line means the prices have risen. On the volatility index graph, a green line means that expected volatility has risen. As we will discuss below, this often means share prices have fallen.

Anyway, here is the graph:

As you can see, the index opened the month at a level of 12 and closed the month at a level just above 14. On 17 August the index rose to a peak of almost 20. If you look again at the graph on the previous page, you will see that on the 17 August the market fell by almost 200 points in a single day. Little wonder, then, that on this day market participants thought that volatility was at its maximum.

Generally, there is an inverse relationship between perceived volatility and market performance. That is, when the market is going well, perceived volatility is low. When the market is performing poorly, perceived volatility is high.

This has a really important implication for share market investors. For reasons that may well be evolutionary, we tend not to notice good news as much as we notice bad news. While it is not a hard and fast rule, daily rises in share market prices tend to be smaller in size but greater in number. That is, there are more days when share market prices rise than there are days when prices fall. However, on those days when prices fall, the change in prices tends to be greater that on days when prices rise.

Nevertheless, as we have shown you in recent months, over the longer-term prices tend to rise. So, the accumulated effect of those relatively more days in which prices increase by a little is greater than the accumulated effect of those relatively few days on which prices fall by a lot. That's quite a mouthful so let's say it again more simply: share markets tend to have lots of days when prices rise by a little and relatively few days when prices fall by a lot. Over time, the little rises tend to offset the big falls.

This is one of the reasons that an investment into a volatile market such as the sharemarket must be taken with a long-term timeframe. Basically, you need to give your investment time to experience a lot of days with little rises so that it can offset the inevitable days with big falls. Trying to make a fast buck is extremely dangerous - you may well find you invest just before the market has one of its big negative turns.

Slow bucks are the best bucks.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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