PRATO CAPITAL

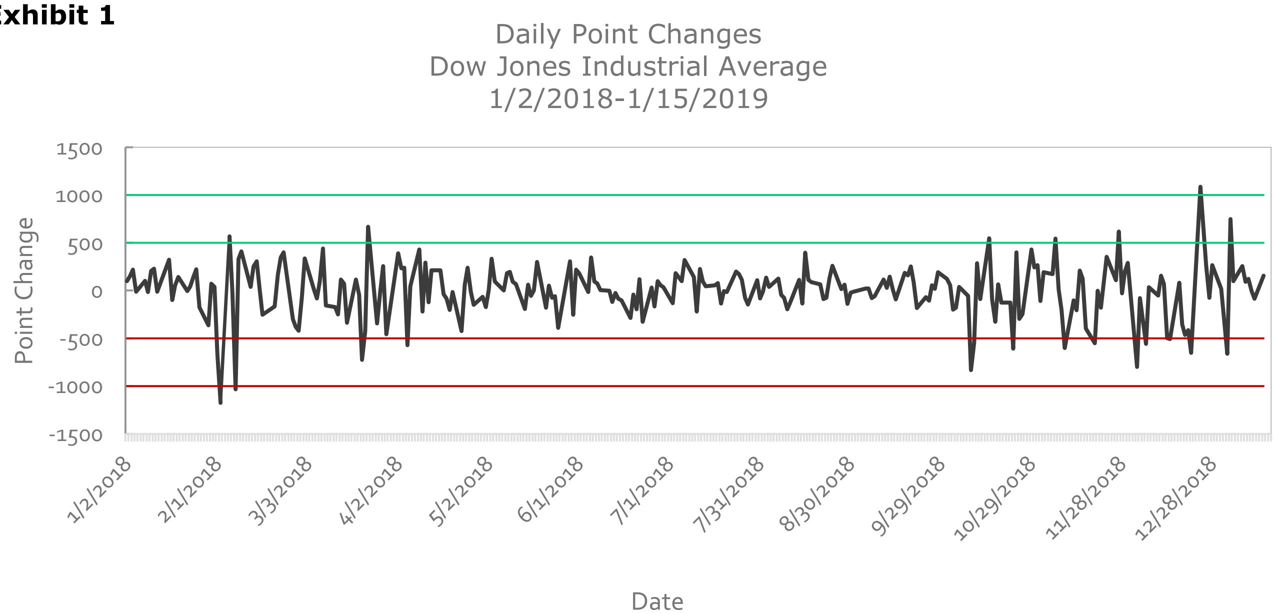
MARKET VOLATILITY

FEBUARY 2019

THE US STOCK MARKETS EXPERIENCED INCREASED VOLATILITY THROUGHOUT 2018 CAUSING A LOT OF UNDUE STRESS AND ANXIOUSNESS TO THE AVERAGE INVESTOR. WHILE IT MAY BE UPSETTING TO SEE DRAMATIC MARKET SWINGS AND ITS SHORT-TERM EFFECTS ON AN INVESTMENT PORTFOLIO, IT IS IMPORTANT TO UNDERSTAND THAT VOLATILITY IS A NORMAL PART OF INVESTING.

After a period of relative calm during 2017, the increase in volatility in the stock market has resulted in renewed anxiety for many investors. Exhibit 1 shows the daily change of the Dow Jones Industrial Average (DJIA)[1] from 1/2/2018.

Exhibit 1



[1] Dow Jones Industrial Average. A price weighted measure of 30 US companies. Property of S&P Dow Jones Indices LLC.

During 2018, the DJIA closed in a range from a high of 26,773 on October 2 to a low of 21,792 on December 24. Although it seems like we often hear about a "500-point" change in the DJIA, that is simply not the case. In 252 open market trading days for 2018, there were only 19 occurrences in which the DJIA experienced a change of more than 500 points.

To put this further in perspective, consider that on October 19, 1987, the DJIA dropped 508 points. At the time, the DJIA was at an all-time high hovering at about 2300 points, resulting in this one-day market losing change of about 22%. Today, with the DJIA up by a factor of 10 since 1987, the same 500-point change or 2% decline is not nearly as dramatic as it was 30 years ago.

CAUSES OF VOLATILITY

On December 18, 2018, commenting on the recent stock market volatility in an interview with Bloomberg Television, U.S. Treasury Secretary Steven Mnuchin called 500-point changes essentially a normal trading day and that "Part of this is a combination of the market presence of high-frequency traders combined with the Volcker Rule."

High-Frequency trading (HFT) refers to computer generated algorithms used by day-traders to move in and out of stock positions within fractions of seconds with the aim of trying to profit from certain undetected market trends. This is accomplished by scanning every available stock exchange to identify said trends and then to trade very quickly on the identified trends. Proponents of HFT point to providing liquidity in the stock exchanges for trades and seeing a drop in the bid-ask price. They also point out that prices of equities are stabilized almost immediately across all markets as any new relevant information is quickly disseminated. Critics of HFT regard this type of algorithmic trading practices as being done without any sense of economic fundamentals other than what trend is happening over very short periods of time.[2] This could potentially lead to 'Flash Crashes' like the one that occurred in 2010, when the DJIA encountered a brief loss of almost 1000 points (-9%)before gaining most of it back by the end of the day.

The Volcker Rule, named after former Federal Reserve Chairman Paul Volcker, is a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Volcker rule generally restricts banking entities from engaging in the speculative trading of securities, commodities futures, derivatives, and from owning or controlling hedge funds or private equity funds[3]. The intent of this law is to prevent banks from making perceived risky investments that have no benefit for their customers but is made only for their own profit. Critics of this law see major banks limiting their trading profits and ability to create liquidity for the bond and equity markets.

As Secretary Mnuchin said in his interview, "Part of this" volatility would include HFT and the Volcker Rule. There are other issues contributing to this short-term volatility, especially in today's global and domestic environment of trade wars, political turmoil and gridlock, and rising interest rates. It has been said many times that the stock markets do not like uncertainty and that volatility is often the end result.

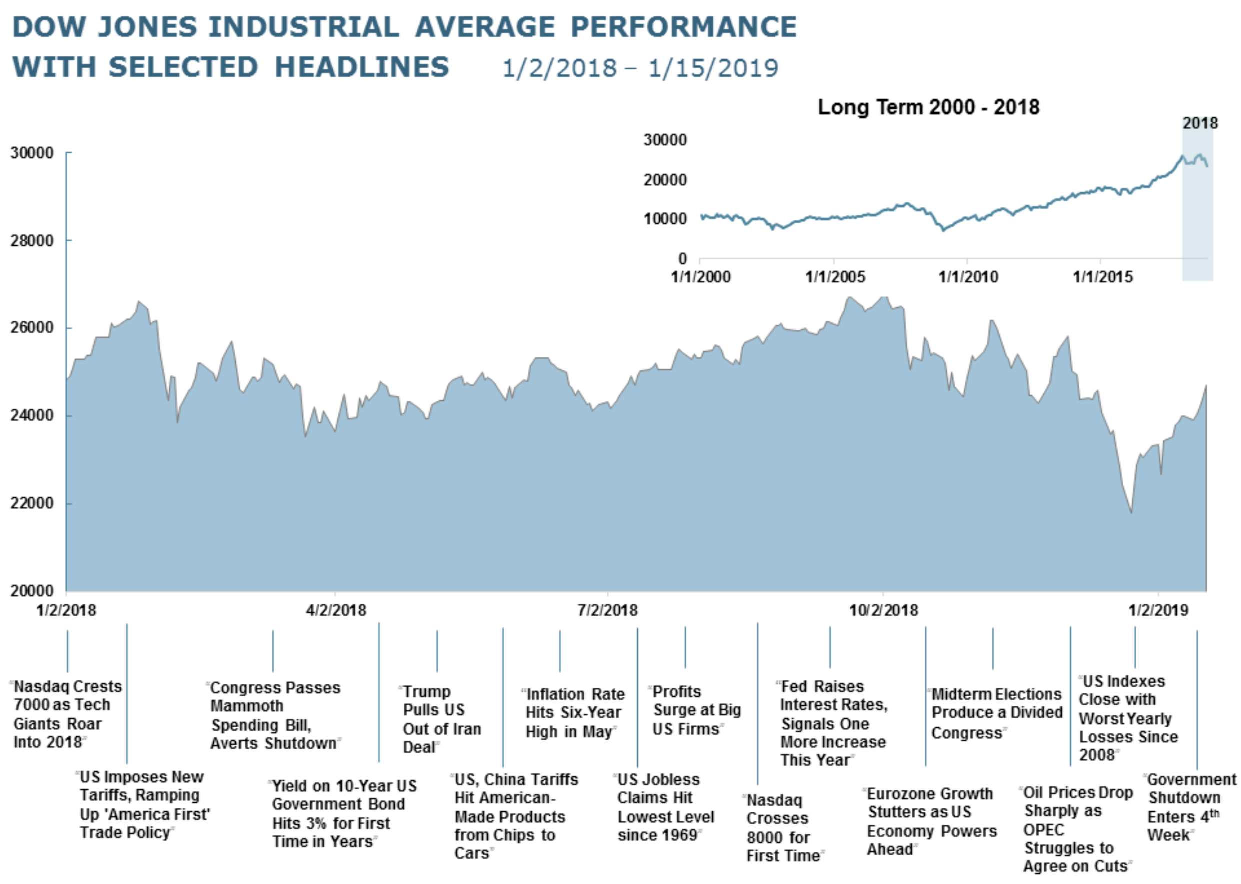
[2] 'High-Frequency Trading Synchronizes Prices in Financial Markets', Austin Gerig, Division of Economic and Risk Analysis U.S. Securities and Exchange Commission, https://www.sec.gov/files/dera-wp-hft-synchronizes.pdf
[3] Agencies Issue Final Rules Implementing the Volcker Rule, https://www.sec.gov/news/press-release/2013-258

VOLATILITY AND WHAT TO DO

At Prato Capital Management, we recognize that volatility is a normal part of investing and although volatility was slightly above average during 2018, it was still close enough to be labeled normal.

In Exhibit 2 below, the large chart shows the performance of the DJIA from 1/2/2018 through 1/15/2019 and the smaller chart in the upper right shows the performance over the longer term since 2000. Starting in January 2018, volatility is clearly present with many ups and downs in the DJIA. Over the long-term, the trend is much smoother with the DJIA increasing over 110% since 2000 and averaging 6.33% in annualized returns.

Exhibit 2



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Please note that although the DJIA has been used for this month’s newsletter, any other major stock average like the S&P 500 or the NASDAQ would show similar short and long-term results.

Conclusion

While market volatility can be nerve-racking for some clients, reacting emotionally and altering long-term investment strategies in response can prove more harmful than helpful. By adhering to a well-thought-out and disciplined investment strategy based on one's personal risk tolerance and their specific Financial Life Plan (which takes into account periods of market volatility), clients may feel better assured during periods of short-term market volatility.

At Prato Capital Management, we remain undeterred in our approach when it comes to the financial planning process as well as our long-term investment philosophy. As always, if you have any questions or concerns about your Financial Life Plan or the short-term volatility of the stock markets, please do not hesitate to call us to discuss.