Stewart Financial

April 2020

Thoughts that count

The all-important objectives

I have lived in the Toronto area my entire life and have an affinity for animals; I have owned several dogs and have been a landlord to my son's fishes over the years. Dogs, fish and almost all other Ontarian animals are docile creatures with extremely few exceptions. There are a few large bears in some northern jurisdictions, but for the most part our animals are not scary. I believe most Canadians know this.

Imagine you are walking on a familiar street in your Canadian hometown when you are approached by someone who tells you there is a tiger loose in the centre of town. Likely, you would not take that comment seriously. You might think you misheard the person, or that they were referring to a child with a stuffed animal. You would not immediately fear for your life.

Now what would happen if a few minutes later a second person told you a tiger was loose in town? Your concern would dramatically heighten. You would begin to wonder if a large cat might possibly be nearby. Significant doubt might remain, but you would start to think about how this could be true.

If a third person came sprinting by you screaming "a tiger is on the next street", you would run. You wouldn't hesitate and you wouldn't care how a tiger made its way to Canada, you would just go.

Originating in the 5^{th} century BC, the Chinese proverb '*Three men make a tiger*' refers to an individual's tendency to accept information if it's repeated by enough people. Interestingly, as the colourfulness of information rises, the number of people needed for dissemination falls. This axiom is as true today as it was 2400 years ago. An interesting mental exercise is to ask yourself how many people must tell you something before you take it as gospel. For some of us, that number is in fact zero, as there are now computer programs writing content on social media without any human involvement at all.

The coronavirus is the first major crisis we have faced in the social media era. Some social media is good, but certainly not all. It has the ability to provide useful information, but it's work to weed out the accurate bits; and few people engage in social media so they can work more. Finding a central authority to trust has never been more difficult. There is no longer a dominant, trusted, non-political, news personality and most polls rank politicians in the least trustworthy class. Walter Cronkite and Winston Churchill have been replaced by anonymous, unverified sources.

At its core, social media is a tool to magnify information beyond its natural network. It turns 'one to one' information exchange into 'one to potentially millions'. Because of this, society gets a glimpse into the feelings of the wider public on a variety of topics from large swaths of society. However, a major criticism of social media's reach is that a lot of authorship is anonymous. This is further complicated because misinformation in not punished. In fact, misinformation is often rewarded through accelerated dissemination. This is a troubling combination when people are starving for information, especially during a crisis. Society has an information complexity problem.

There is an antidote to help combat information complexity. When we consume any content, whether from a traditional source (newspaper or TV) or not (social media), we need to first consider the objective of the creator. Intent always precedes content. Always. Filtered through the lens of intention, we can give context to an otherwise random story or piece of data.

Every author has an agenda and they don't need to have a harmful intent to cause us strife. Anyone crafting content for public consumption presents their message with their own personal and limited motivation in mind. The epidemiologist writes ultra-conservatively because they are trying to save lives. The politician is vague and noncommittal because they are trying to appeal to everybody. The business leader says things to promote their brand. The hedge fund manager goes on TV and promotes behaviour which will benefit the positioning in their own account. The Facebook poster is bored and is trying to sow discord. Each creator has their own reasoning for what and why they promote. Unfortunately, motivation is rarely disclosed up front.

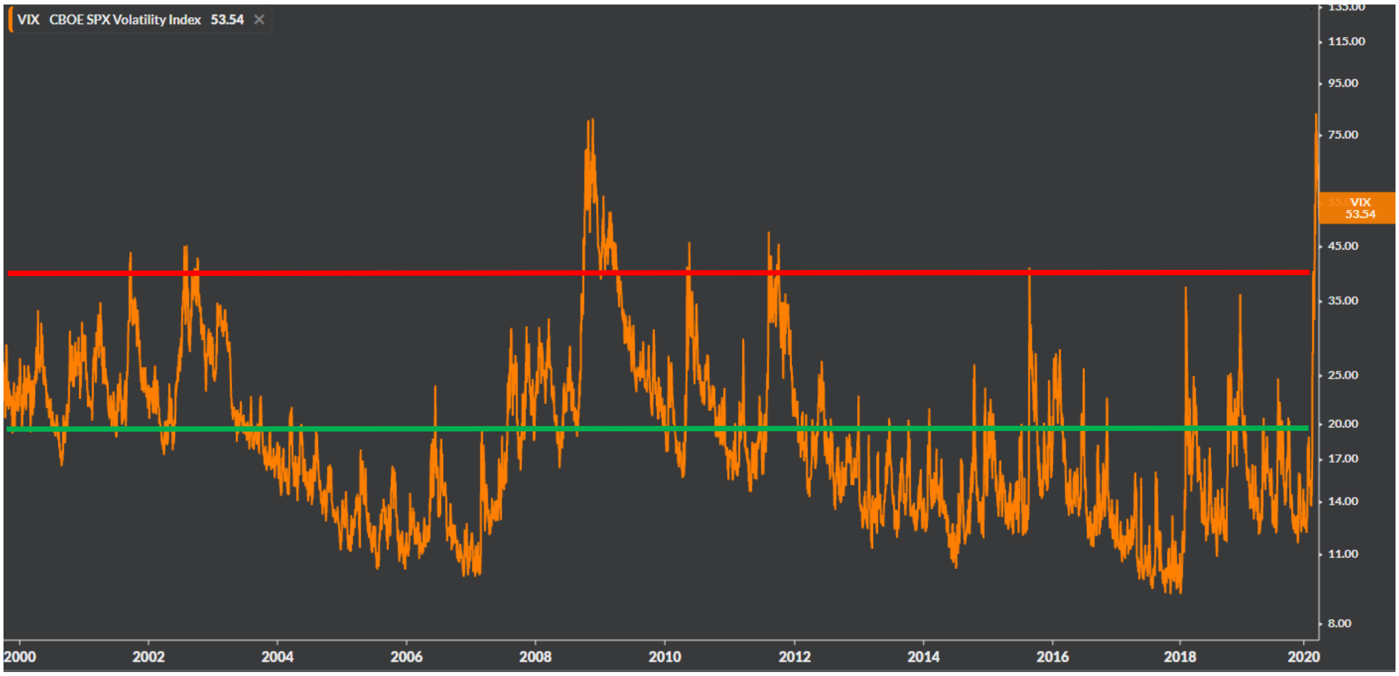
What would social media look like if it was no longer anonymous and you had to back up your comments, especially consequential pronouncements, with real money? That would be a game changer. While many people freely comment on how some future event will unfold, precious few would offer the same advice in the form of a wager. A monetary wager acts as a truth serum of sorts, as it filters out any ideas that are not backed by exceptional confidence.

In 1993, something was created that provides us with information about what the larger investment world is thinking similar to the way social media does. This information source possesses the power of 'one to many' information exchange, but has clear motives. It is also backed by billions of dollars. It is a statistic called VIX.

All investors expect their investments to grow. When investors are anxious about the future, they fear a large loss, which would be a deviation from their expectation. When they are not anxious, they don't think about loss at all, and so expect their investments will either grow slowly or realize a surprise gain, which is in line with their expectations. For investors, any deviation from expectations is 'volatility'. The more anxiety someone has about the future, the more they worry they won't meet their expectations. In other words, they believe volatility will increase.

There are two ways to anticipate future volatility; 1) look at similar periods in history and assume a repeat pattern or 2) look forward. But if we simply look forward, what do we use as a guide? Here is where we can use the VIX to help. In addition to buying investments in stock and bond markets today, large sophisticated investors place wagers today on what they anticipate future prices to be. These bets are transparent and trade tens of billions of dollars every day.

VIX is a measure of these wagers and its output is a signal of how significant volatility will be in the near future (specifically the next 30 days). Below is a graph of VIX over the past 20 years.



The orange line tracks the daily value of VIX. While the calculation is complex, the output is straightforward. A value below 20 (green line) represents a normal expectation of future volatility. In other words, market participants are not anticipating a deviation from their expectations at all; they expect their investments will grow, as usual, in the period ahead. When the value ranges from 20 to 40, this signals that the market is getting worried that their expectations will not be met. Values above 40 (red line) mean the market is assuming significant volatility ahead. In summary, values below 20 mean stress-free investing for the period ahead, and values above 40 mean the opposite.

Over the past 2 decades, the VIX has averaged a value below 20. This makes sense, as most of the time the markets hum along without much fanfare. From time to time however, market participants expect volatility to pick up dramatically. This usually coincides with a major economic event or large-scale social change. We can see the peaks above 40 every few years (2001, 2002, 2008, 2010, 2011, 2015 and 2020).

There are two reasons why this is important:

1) While most investors mentally accept that the proper strategy for investing is to buy low and sell higher, putting this into practice is difficult. However, generally the only way to buy at a low price is when volatility is high. Historically, when the VIX moves above 40, future rates of return are higher than average. When VIX reaches extreme high values, future returns are at their highest potential.

2) We can use VIX as a cue to tell us where volatility is heading. When VIX is rising quickly, we can assume future volatility is coming, and when it is falling, a more stable investing environment is likely ahead. This is especially important information for nervous investors as a falling VIX means volatility should recede.

As we see in the graph, the maximum peak level of VIX has been 80, which has only been reached twice; November 2008 and this month (though the current reading as of March 31 has dropped to 53). If history is a guide, this is important for the period ahead for two reasons; a) it is highly possible peak volatility has arrived and should decrease from here b) future investment returns should be higher than average.

When I gather information that informs our investment process, I try first to understand the motivation behind the authorship of the information I am consuming. I try to imagine myself in the author's shoes and ask why are they sharing this information and why right now? If I cannot ascertain the authors objectives, its probative value must be heavily discounted, if not ignored.

In the proverb '*Three men make a tiger'*, we don't know the motivation for their pronouncements. Should we assume they were being cautious and helpful, were they themselves misguided or did they have an ulterior motive? Whatever their objectives were, their information was ultimately believed. In the case of investing, we have more time to evaluate information; we won't be facing a wild animal. We would be wise to spend a great deal of that time thinking about the motives of the authors we read. I will continue to search out the counsel of data like the VIX. In this way I am less likely to be shaped by misleading speculations and will be better prepared for the period we face ahead.

*Btw, my motivation for writing this letter is to provide some helpful context regarding the current and future state of the markets to our valued clients. Stay safe.

Your *trying to limit my kids' reliance on iPad games to below 24 hours a day during the lockdown* investment advisor,

Duncan Stewart, MBA, CIMA, FCSI, CFP, CPWA
duncan@stewartfinancial.ca / duncan@manulifesecurities.ca