F.L.PUTNAM
INVESTMENT MANAGEMENT COMPANY

MARKET INSIGHT
MARCH 2014
VOLUME 13, ISSUE 1

JOHN V. CARBERRY
President
jcarberry@flputnam.com

ELLEN FLAHERTY
Sr. Vice President, Chief Operating Officer
eflaherty@flputnam.com

SUSANNE STAUFFER
Sr. Vice President , Portfolio Manager
sstauffer@flputnam.com

ROBERTSON P. BREED, CFA
Sr. Vice President, Portfolio Manager
rbreed@flputnam.com

STEVEN N. VIOLIN, CFA
Sr. Vice President, Portfolio manager
sviolin@flputnam.com

ELLEN K. HAZEN, CFA
Vice President, Portfolio Manager
ehazen@flputnam.com

D.J. SHAUGHNESSY, CFA
Vice President, Portfolio Manager
dshaughnessy@flputnam.com

ANDREW B. WETZEL, CFA
Vice President, Research Analyst
awetzel@flputnam.com

MICHELLE M. BUCKLEY
Research Analyst
mbuckley@flputnam.com

CHRISTIAN D. MCVEY
Sr. Vice President, Marketing
cmcvey@flputnam.com

WENDY M. BUSH
Vice President, Marketing
wbush@flputnam.com

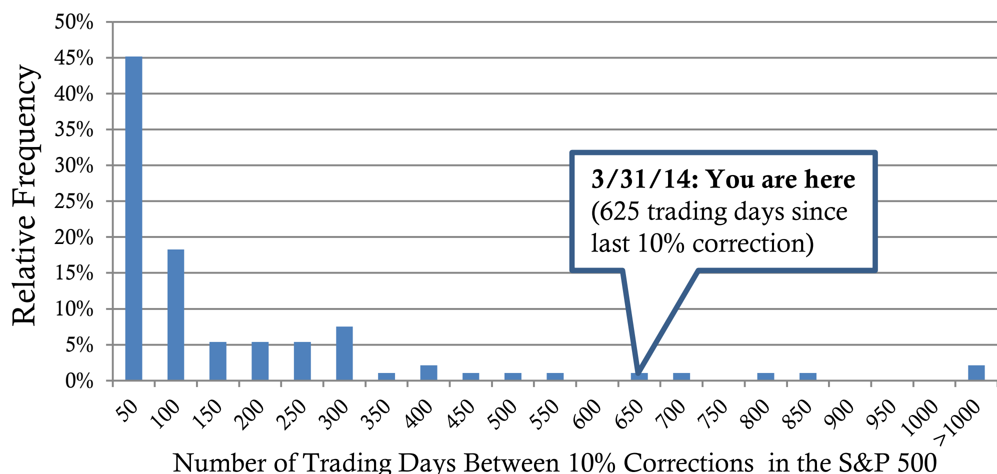
STOCK MARKET VOLATILITY: RISKY BUSINESS?

BY STEVEN N. VIOLIN, CFA, SENIOR VICE PRESIDENT

The S&P 500 Stock Market Index returned 1.80% in the first quarter of 2014, which came as a surprise to many investors following the 32% return in 2013. Not only were returns lower than many stock market participants had hoped, but the stock market rose and fell significantly during the quarter. In fact, the most important development during the quarter may have been this underappreciated change in market volatility.

At the beginning of the year many surveys of investors indicated an unusual level of complacency. This may have been due to the combination of high returns and low volatility that had persisted for over two years. It is easy to forget after a year like 2013 that declines of 5% and 10% are quite common in the stock market. Investor complacency did not last long in early 2014 as disappointing economic data and rising geopolitical tensions surrounding the political crisis in Ukraine led to a significant decline in the stock market during the second half of January. In fact, the Dow Jones Industrial Average lost over 1100 points or about 6.7% over the 12 trading sessions that ended February 3rd.

RELATIVE FREQUENCY OF INTERVALS BETWEEN 10% CORRECTIONS IN THE S&P 500



Data Source: Ned Davis Research, Inc.[1]

Despite the volatility of the first quarter, the stock market remains long overdue for a larger "correction" of 10% or more. On average, such corrections have occurred every 162 trading days (roughly every 8 months) from 1928 through this year. At the end of the quarter it had been 625 trading days (nearly two and a half years) since the last 10% decline in the S&P 500. The chart above illustrates how uncommon this is. There are only 6 other instances of intervals this long between corrections in the past 85 years. As a result, the volatility experienced during the first quarter could be the beginning of a trend.

One of the causes of this increased volatility is simply the passage of time and maturing of a stock market cycle. It may be hard to believe, but it is now more than 5 years ago that the S&P 500 reached its nadir of 666 during the financial crisis. The painful memories of 2008-2009 are clearly fading for many investors and some aspects of the "irrational exuberance" that characterized the late 1990s are beginning to recur. Isolated examples of speculation in the stock market are relatively easy to observe as extraordinary valuations have been assigned to skyrocketing IPOs (e.g., Twitter) and corporate acquisitions (e.g., WhatsApp). Other markets are also beginning to show signs of increased risk taking. According to The Economist, the average home price to household income ratio in San Francisco is now 20% above the long term average as prices have jumped and bidding wars have become commonplace. This ratio peaked at 63% above the historical average in 2005. Credit markets are also starting to show signs of investors behaving badly. A recent Forbes article reported that the issuance of a particularly risky type of loan called a second-lien leveraged loan had more than doubled so far this year versus the same period last year to levels last seen in 2007. These echoes of past bubbles in technology stocks, real estate, and credit markets set the stage for increased volatility in financial markets.

Monetary policy has also played a role in rising stock market volatility. In recent years interest rates available for traditionally stable investments have been so low that investors have faced risk from inflation and rising interest rates. Additional risk had to be taken if investors hoped to exceed an explicit inflation target of 2%. The result has been an environment where there are no safe investment options and risk is everywhere but is nearly invisible. This monetary policy stimulus that has fostered increased risk taking was reduced for the first time this quarter, and risk became more visible as a result. While the normalization of monetary policy could result in higher volatility and lower returns in the stock market, from a longer term perspective the end of the Federal Reserve's manipulation of long term interest rates and asset values is encouraging and could provide greater economic stability.

While volatility has increased and the stock market remains overdue for a decline of 10% or more, historical context illustrates that this is more of a return to normal financial markets than a worrisome development that requires a change in investment strategy. In addition, despite increased volatility, the economic outlook remains favorable, corporate America remains in solid financial health, and stock market valuations are somewhat elevated but not egregiously so. Interest rates also remain low despite reduced monetary policy stimulus so there are still no safe investment options, although holding an adequate allocation to cash and bonds can still help reduce risk, if not increase returns.

Ultimately, we remain optimistic on the economy and stock market, but we are preparing for higher volatility. Over time, our disciplined approach to investing may even allow us to take advantage of a return to more normal levels of market volatility, as volatility can be a source opportunity as well as risk.

[1.] **Copyright 2014 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/.**

2014 MARKET DIARY		
	3/31/14	**YTD Change***
Dow Jones Industrials	16,457.66	-0.15 %
NASDAQ	4,198.99	0.83 %
S&P 500	1,872.34	1.80 %
Russell 2000	1,173.04	1.12 %
10-Year Treasury Bond Yield	2.72 %	-31 b.p.