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Pondering Volatility and Meteorology

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About a month ago, a strange weather system rolled its way through the greater Kansas City metropolitan area. It was punctuated by dark grey, ominous skies, high winds and eventually, large wet flakes of fluttering snow. The snowfall was a minimal one to two inches in accumulation and the storm system that had reared its ugly head in the mid-morning hours was gone by lunchtime. The hovering dark clouds soon began to break up and drift as the sun awakened from its slumber and slowly showed itself. By 3pm, what had been a cloudy, dreary, snowy, disgusting day became a bright, brilliant, radiant and glowing mixture of sunlight, blue skies and warmer temperatures.

The weather dynamic of a day that had begun one way and evolved so quickly and almost otherworldly into something so different, was fascinating to me in the stunning alacrity with which things changed. The folks at *Wikipedia* define the term Meteorological Phenomena as “observable weather events which illuminate, and are explained by the science of meteorology. Those events are bound by the variables that exist in Earth’s atmosphere; temperature, air pressure, water vapor and the gradients and interactions of each variable, and how they change in time.”¹ Each variable on this particular day was changing rapidly and the transformation from dark gray to sunny and bright blue was somewhat astonishing.

Perhaps what made this day in February so remarkable to me was the abject lack of days like it in recent memory. The rapid swings in temperatures, cloud cover and atmospheric conditions have largely been absent in the Kansas City area in 2012 as generally calm, unseasonably warm conditions have pervaded. The relative calmness and soothing way-warmer-than-normal temps that have settled across much of America’s midsection this year present a thought provoking (to me anyway) parallel to volatility, or the lack thereof, that has asserted itself as one defining quality of the 2012 US financial markets.

There is simply no denying that just as we have experienced an ever-present prolonged winter warming trend, we have also been presented with a stock market that has been devoid of the type of alarming, aortic-rupturing volatility that we so often slogged through in the second half of 2011. But do we not live in fear that just like the arctic blast late season snow storm that churns its way towards us from the Canadian hinterlands, our volatility-free pleasantness and its corresponding market strength will wither and die like the early-blooming March flower? We certainly corroborate with the fear compulsion.

The VIX, the measure of market volatility used by The Chicago Board Options Exchange, notched its lowest level since 2007 last week. A growing dossier of positive-leaning economic news has buoyed the bull case for the market and 2012 has been known so far for its steady and somewhat remarkably strong returns and correspondingly low volatility. To put things in perspective, the VIX is currently sitting at a level around 15. Last August, amidst the turmoil generated by the Standard and Poors downgrade of the USA’s credit rating, the index nearly hit 50. It’s subsequent decline this year and relative hibernation has been a welcome development. Will this sanguinity and market harmony continue unabated? The so called smart money would seem to argue it will not. VIX futures are indicating that our low-vol party may be reaching its conclusion as soon as April which notched a number around 19.30. The August contract recently traded around 26.²



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While certainly not a trend that one would deem alarming, the roughly 10 point swing in VIX futures pricing from where we stand today to just five months from now, gives an intriguing indication of where the market thinks we are heading.

The punditry out on the airwaves and internet offer an interesting diaspora of varying opinions about the staying power of 2012's first quarter rally. We've recently been bludgeoned over the head with positive missives and projections from the likes of Bank of America, Credit Suisse, JP Morgan and BlackRock. Peter Oppenheimer from Goldman Sachs took the rhetoric one further by proclaiming stocks to be at a "once in a generation" buying opportunity.³

But there certainly are still those that would preach caution if not outright skepticism at the market's recent run and its ability to maintain the impressive gains. Consider this barb from quant-curmudgeon John Hussman, "valuations are rich instead of reasonable, prices are strenuously overbought instead of oversold, investor sentiment is exuberant rather than fearful, the growing technical divergences are negative rather than positive, corporate insiders are frantically selling instead of buying, stocks are grasping at speculative highs instead of multi-year lows, and risk premiums are razor-thin instead of satisfactory."⁴ Whew! That's enough to ruin your weekend. Are Hussman's bearish deliberations the embodiment of the metaphorical late season winter storm that lingers and catches us all off guard?

Additionally, there is the issue of the looming release of first quarter earnings. This could represent another potential quagmire as prognostications for earnings growth in the first quarter are as low as .5%. Six of the ten sectors within the S&P 500 are projected to see earnings declines and this is on top of a cavalcade of companies who have already preannounced negative results. The level of negative preannouncements is now at its highest since the March 2009 market doldrums.⁵ Put more simply, the S&P 500 is up almost 30% in the past five months and that price appreciation is built partially on the expectation that actual company results are improving, thus signifying a healthier economy. If the bellweather companies that comprise the major indexes collectively release lackluster earnings data for the first quarter, what will this mean for stock prices? How could they possibly warrant higher valuations if the numbers prove disappointing? To be fair, strength in stock prices doesn't always correlate to strong earnings, but we would argue that at some point there needs to be a foundation laid by solid fundamentals to support a prolonged rally in equities. This is certainly not to say that the major Indexes couldn't churn along throughout the year delivering further gains to investors brave enough to muddle through. With a stabilized European situation, steadily improving employment, manufacturing, consumer spending and housing metrics in the US, inflationary normalcy defined by modestly declining food and energy prices, and earnings results that are generally in line with already lowered and achievable estimates, we could begin to understand how one could piece together the muted bull case for stocks.

All that being said, my one inquiry would be this: it's late March and we've seen temperatures in the 70's and 80's in the American Midwest over the past two weeks. The flowers are blooming and filling the air with fragrant scents. Have you put your winter coat away for the year? Are your hat, gloves and scarf stocked neatly in some attic or cedar closet so that they may rest comfortably until next winter? Mine aren't. Mine are front and center in my house just in case that late season winter storm blasts through town. Fear and cowardice are not desirable qualities in the context of greater life. We never wish to coexist under such conditions but in the financial markets a little fear and a little cowardice can be a reassuring security blanket against all that is unknown.

We manage portfolios with this notion in mind. It can often be overtly tempting to shift one's approach in convalescence towards the emotion that a market rally can engender. Our focus remains steadfast on high quality securities sourced at perceived undervalued price points. It also lies soundly in a prudent mix of bonds as well as stocks. Finally, the exuberance of the market does not cloud our view that a measure of dry powder can make a world of difference



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when valuations tilt toward the exceedingly attractive. We strive to construct portfolios that exhibit the qualities of preparedness, thoughtfulness and perhaps more than anything, a meaningful dose of caution. This abject lack of flash provides us daily comfort that no matter the forecast and no matter the short term permutations, we stand confident that our clients are positioned strongly over the long term. The famed British sea captain Lord Horatio Nelson (no relation) was known to exclaim, "I cannot command winds and weather".⁶ These are simple but profound words that correlate to our inability to affect market movements and the ongoing importance of positioning our clients to withstand those macro elements that are out of our control.

Sometimes the weather, of all things, reminds us of how quickly an unpleasant, gloomy, ugly and depressing situation can morph into a bright, lovely, glowing and wonderful outcome. Correspondingly, it can also lull us into a temporary hypnosis where we get too comfortable, too relaxed, and too complacent. I've got my golf clubs ready to go this weekend. My golf shoes are polished and my short sleeved golf shirt and shorts are washed and ironed. But I'll be bringing along some pants and a warm jacket as well.....just in case.

¹ <http://en.wikipedia.org/wiki/Meteorology>

² <http://money.cnn.com/2012/03/15/markets/fear-index-vix/index.htm>

³ <http://www.minyanville.com/business-news/markets/articles/255EIXIC-ORCL-GOOG-JPM-TRP-home/3/21/2012/id/40003>

⁴ <http://www.hussmanfunds.com/wmc/wmc120319.htm>

⁵ <http://www.cnbc.com/id/46785093>

⁶ <http://www.inspirationalstories.com/quotes/i-cannot-command-winds-and-weather-of-horatio-nelson-quote/>



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