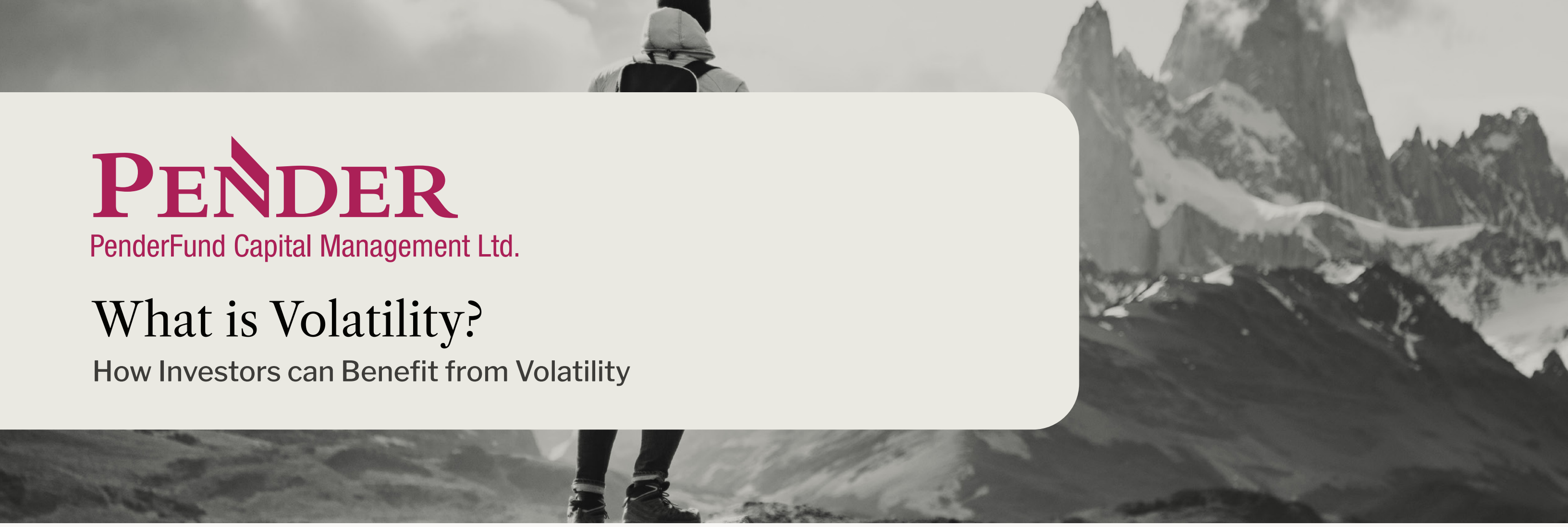

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PenderFund Capital Management Ltd.

What is Volatility?

How Investors can Benefit from Volatility

In the investing world, price volatility is defined by how far the price of a stock, bond, or other financial asset may deviate from its mean price within a given period. That is still the technical definition but over the past 30 years, the general understanding of volatility has changed. Today, the term volatility is commonly used as shorthand for a measure of risk.

Investment assets such stocks, bonds, and other alternative types of assets are categorized on their price volatility, among other criteria. For example, if the price of a publicly traded stock jumps around a great deal, it would be deemed to have high price volatility.

Beta is the term used to give an approximate measure of a security's price volatility relative to the general market, such as the S&P 500. The market is assigned a beta of 1.0. If a security's beta is greater than 1.0, it denotes greater price volatility. However, such common beliefs that risk can be quantified, that price is a useful tool to measure risk, and that past data can be used to forecast risk are open to debate.

There's a mismatch between how the investment industry thinks about volatility and the way regular people do. Most individual investors do not think of risk in technical terms such as "standard deviation from the mean", rather they experience volatility as rapid changes in the price of an asset they own and the risk of a drop, perhaps even a permanent drop, in the value of their portfolio. Naturally, this causes stress and anxiety.

It is important to remember that volatility is a feature of capital markets, not a bug. Volatility is embedded in markets, and it is the "cost" of investing. In other words, to benefit from the future gains, investors must anticipate and accept a certain amount of price volatility from time-to-time.

However, it's important to know that the price of an asset can move based on a variety of factors, including investor mood. These price changes may not reflect the intrinsic value of a business whatsoever.

Different causes of volatility

Market volatility has many causes ranging from geopolitical instability or a global pandemic to the perceived likelihood of a recession, diminished earnings outlook, reduced liquidity, changes in market sentiment and investor confidence, and the growing correlation among asset classes and global markets.

During bull markets, prices continue to rise because investors experience irrational exuberance and supreme confidence that "this time is different". As irrational as it may seem after the fact, during these periods, investors expect prices to rise indefinitely.

In the 1960s this led to the Nifty Fifty, a group of 50 blue-chip stocks that investors bought regardless of price based on the belief that the prices of these stocks would grow to the sky. (Spoiler alert: they didn't.) More recently, investors fell over themselves to bid up prices for the FAAMGs—Facebook, Amazon, Apple, Microsoft, and Google—mega-cap high-tech stocks which could do no wrong and represented a large weighting of major stock indices, mutual funds, and ETFs in addition to individual and institutional portfolios.

However, once the market mood shifts from TINA FOMO (“there is no alternative”; “fear of missing out”) to FOHO (“fear of holding on”), the herd becomes pessimistic and risk averse and goes from being net buyers to net sellers.

This kind of correlated investor behavior creates market drawdowns, a polite way of saying market crashes. When the majority of investors are running for the exits trying to sell, prices can drop precipitously. This causes rising volatility which begets rising volatility. To make matters worse, when major asset classes, such as stocks and bonds, begin to move in unison, there are few places for investors to hide. This is a situation that investors experienced in 2022 when government bonds, which normally are negatively correlated with equity markets during sharp declines, lost ground due to rising yields in an effort by central banks to tamp rising inflation.

When asset prices are falling all around, investors tend to panic which inflames volatility even further. Eventually the drawdowns are taken too far and whether for behavioral or fundamental reasons, investors begin to wade back into the market.

Traditional ways to manage volatility

A common reaction to market crashes is to raise cash and sit on the sidelines. Until recently, money markets and bonds provided so little yield or negative yield in real terms that investors were disinclined to hold too much cash. As yields rise, holding cash does provide some return but, over the long-term, cash will underperform relative to stocks and bonds.

Diversification is a traditional way to smooth out portfolio volatility. Historically, bonds and equities are negatively correlated: when the prices of one asset class are dropping, the prices of the other are usually rising. When a portfolio contains an allocation to both stocks and bonds, their see-saw relationship can help smooth out periods of high market volatility and protect the value of the portfolio.

Likewise, diversifying into global markets and alternative assets such as real estate, commodities, farmland, even art and collectibles has been shown to tamp portfolio volatility in the past. However, not all these assets are suitable for all investors.

Hedge funds and specialty low volatility funds which may include covered call and other options strategies, have also been touted as providing some protection from extreme market volatility but the results are mixed.

How Pender manages volatility

More recently, liquid alternative strategies have become available to regular investors through mutual funds. These flexible mandate strategies may involve investing in bonds, equities, mergers and acquisitions, and risk arbitrage to generate non-correlated returns and smooth out portfolio volatility. At Pender, we have launched several liquid alternative funds. These include:

- The Pender Alternative Absolute Return Fund which is a high-yield focused credit strategy.
- The Pender Alternative Arbitrage Fund which is aims to produce consistent, low volatility absolute returns by primarily investing in merger arbitrage opportunities; in addition, we offer a leveraged version of this fund, Pender Alternative Arbitrage Plus Fund.
- The Pender Alternative Multi-Strategy Income Fund which aims to generate returns through current income and capital appreciation, while being sufficiently diversified to mitigate volatility and preserve capital.
- The Pender Alternative Special Situations Fund which aims to achieve long-term capital appreciation by investing in North American equities, debt, and other securities while mitigating volatility and preserving capital.

At Pender, we view volatility as a potential opportunity to build positions in quality businesses for the long term. We know that price volatility does not necessarily reflect the intrinsic value of a business. In fact, negative price dislocations based on investor mood are momentary lapses in market efficiency. They can represent an attractive price to create a position or build on an existing investment.

Whether a company and its stock are popular in the short term does not concern us providing we understand the merits of the business and its long-term potential to generate positive returns.

Conclusion: The future of volatility

Despite reams of data that demonstrate how investor behavior harms returns, the performance gap between the average U.S. equity fund investor and the S&P 500 grew in 2021 compared to previous years. In the 2022 Dalbar report, the average investor returned 18.39% compared to the benchmark return of 28.71% for the 12 months ending December 31, 2021. It is the third largest gap since 1985 when Dalbar began collecting data.

A previous Dalbar Institute study reviewed investor transactions from 1992 to 2012 and found that the average holding period for the typical investor was six months. This indicates that the typical investor is using the stock market for trading based on short-term news, price guessing, or wishful thinking. The result, in aggregate, is a significant underperformance compared to the benchmark index. What Really Matters?

Human psychology is not expected to change any time soon. The typical investor does not welcome volatility, though it is a feature of all markets and must be addressed. One way to address this for the volatility-averse investor is through specialized strategies, like liquid alternatives, which aim to smooth the ups-and-downs while delivering positive returns.

To learn more about Pender Liquid Alternative Funds, click here.

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