

Let's talk about volatility

Did it happen? Didn't it? Are we still waiting for it? These are Questions we have asked ourselves about the "re-opening trade" and recovery of the UK stock market in 2021, specifically the Small and Mid-cap sectors. Our view, pre-pandemic, was that the UK was trading at a discount to global markets. This opportunity was then exacerbated by a slower acceleration off the March 2020 lows, meaning the UK looked very much like the laggard in the developed markets. With Brexit in the rear view mirror and the UK consumer looking set to open their wallets in 2021, it looked like a no brainer to get overweight UK domestic companies in AIM, and 250 over that of the FTSE 100 which was full of internationals.

And that's exactly how clients have been invested this year and I am happy to say, thus far, that's been a good call. The FTSE 250 YTD is up 18% against the 100's 13% and that's just the main indexes. If you bake in active management (which I have been saying is the way to invest into this market), YTD returns in the UK small and mid-caps move up to the 30% region. Well, at least that's what TAM's clients are getting from their investments into Chelverton and CRUX UK special situations. So yes, it's been the right call from a sector perspective which has been supercharged by stellar active management.

The downside is that with the S&P 500 up some 20% YTD Vs the 100's 13%, the UK's "catch up" hasn't yet come to fruition; despite TAM's UK funds delivering the goods over and above even the US indexes. Some might peg this lag as a chance waiting to happen, whilst others might cite this as evidence the notion of a UK catch up is fool's gold.

We still back the UK mid cap and small cap space; there are some phenomenal companies in these markets servicing both domestic and international businesses and consumers. These companies are delivering double digit growth in a post-COVID world and doing so against the backdrop of an economy which is making meaningful steps to settle its COVID debt with tax hikes and talks of QE tapering far in advance of the US Federal Reserve (Fed). Furthermore, with the UK government looking to tear down much of the EU's barriers to home grown innovation via its rules on a "level playing field", this should inject further stimulus into our innovative smaller cap names to the benefit of those willing to invest into them.

So, the long-term looks good for the UK in my opinion but, in the short-term, the aggressive acceleration in markets will no doubt lead to volatility. Volatility is not the enemy of positive returns as any hedge fund will tell you, it just needs to be handled in the right way.

Despite the UK market lagging its international peers, it has been rallying in a straight line since January 1st and whilst that's fantastic, we must concede that all good things need to 'take a breather' at some junction. The US market has now passed over 200 days since it had a 5% sell-off, which is one of the longest in history and keeps getting longer. This alone is a concern and makes the likelihood of this happening sooner rather than later more of a possibility. It's always worth reminding investors after comments like the ones I have made, that a pullback in markets is entirely normal and very much expected. It's the sign of a properly functioning market in which exuberance and fear exist as opposing forces. Too much exuberance and we risk losing our ability to invest rationally.

To me, the main risk or catalyst of a moderated correction oscillates around central banks and the word "taper", which is to say the removal of stimulus which is commonly referred to as "QE". I just don't think this is fully in the price yet.

If the Fed surprise the market with an announcement about the tapering of stimulus too soon, this could cause panic, especially with US economic growth numbers looking like they could plateau. So my call would be that a tightening Fed collides with an economy which is treading water against an inflationary backdrop. This could well cause investors to start moving chips off the table in the short-term. Yes, I think they will eventually put them back on the table again.

Is there any evidence? Well, I have been watching "volatility" recently and it's been telling a different story to the positivity seen in the stock market. The VIX is essentially a measure of how volatile the stock market is. It's underwritten by derivatives called "options". Rather than be that guy who tries to put you to sleep by explaining options, I will just say that buying an option is like buying an insurance policy. It pays out if the stock market sells off.

In August, these insurance policies (AKA options contracts) were changing hands with such velocity that

they started to trade in the same way as the period before the 2008 financial crisis. That tells me investors are becoming skittish by buying and selling these options in large volumes and doing it every day. Why? A few reasons, but broadly speaking, investors can't make up their mind if we are advancing another 20% or pulling back. Not a reason to panic but definitely something to take note of.

More recently, options traders I have been speaking to say the volume of options being purchased (not sold) to protect themselves against the market pulling back has reached one of the highest levels in history. This tells me that institutional investors are putting their armour on for Q4. What's also interesting, is bulls (investors positive about the market) outnumber bears (investors pessimistic about the market) by ten to one which is another sign that this market is becoming lopsided.

TAM is, as always, at the centre of this market and we have been investing into funds who buy into these options when they are cheap or "out of the money", then when the whole market is clamouring for protection against a sell-off, these funds sell these options at large profits. This is a fantastic way to own investments which are rallying when everything else is selling off, but also a great diversifying investment to ensure clients' capital is protected that much more.

So to recap, yes, we want to stay with our investment into UK assets because we think a combination of top notch active management and high quality companies in an undervalued market, remains as good as any reason to be invested into a sector or geographic market.

Alas, we think there is going to be some turbulence over the short-term given how good we have had it since Q2 2020 and, as always, we must prepare our clients' investment portfolios to go through, what we believe, could be a more challenging environment.

If you'd like to have a chat to us about anything from this note, and our services in general, please do not hesitate to contact me.

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