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Don't Blame Low Volatility on Complacency

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Over the last few weeks many have speculated that low volatility must mean that investors are complacent. As I was writing this post, in fact, an email came through about a new volatility study from ConvergEx showing that half of their study respondents perceived investors to be too complacent, especially when it came to equity markets. Between the Ukraine, the Middle East, multi-asset bank scandals and bond and equity markets so high that a correction must be on its way, what other explanation could there be for the fear gauge hovering in the 10-12 range besides complacency?

I don't know about you, but I have yet to meet an institutional investor who is ever complacent. Every single day is a mad dash to increase returns, attract investment dollars and do whatever is necessary to get a big bonus. This is true across the country, whether a hedge fund in New Mexico or an Asset Manager in NY. So no, complacent investors are not causing low volatility and low volatility is not causing investors to be complacent. And for the small few out there who are in fact complacent and hence unhedged, time to rethink your positioning.

So what does low volatility mean? The Fed continues to be transparent about its bond buying and low rate policy, and the market believes them. A rate rise is inevitable and QE will end in a few months, but the market feels either it knows exactly how and when those events will transpire or that its portfolios are properly positioned for whenever it does.

As for the equity market, that is starting to feel a bit more like irrational exuberance than complacency. What I find interesting is that no one is admitting to being complacent, but as the ConvergEx study shows market participants are happy to put that label on others.

Nevertheless, low vol in equity markets is starting to feel like a cyclical phenomenon. The last two long stretches of low volatility, pre dot-com and post dot-com, lasted about three years or so. We're only about a year in, which might lead you to believe we still have some ways to go. Secondly, talk that the equity markets are overvalued and can't go any higher is something we've all heard before. Will it go down eventually? Yes. Will there be more vol eventually? Of course. But trying to guess when is nearly impossible. This is in part why some investors are staying on the sidelines. Not only is guessing the downturn near impossible, but markets are expecting a downturn in both equities and fixed income, leaving many - especially retail investors - with no where to turn.

Bottom line, there are real economic explanations for low volatility, but the catch all of complacency is not one of them.

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