



MULTI-ASSET

PODCAST: Market Volatility: The Factors, Risks and Opportunities

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Our emotional reactions can influence our behavior in many ways—including investing. When markets face heightened volatility, many investors start to panic in fear—sometimes to the detriment of their long-term financial goals. Wylie Tollette, head of Client Investment Solutions, Franklin Templeton Multi-Asset Solutions, looks at the factors driving the latest bout of market volatility, including the impact of short-term investor behavior. He says times of volatility present opportunities to rebalance one's portfolio, but adds investors shouldn't wait for the market to tumble to start thinking about risk management.



TALKING MARKETS WITH FRANKLIN TEMPLETON INVESTMENTS

Here are some highlights of Wylie's views represented in the [podcast](#):

- I think the latest bout of market volatility resulted from dashed hopes of a few incremental investors wanting a more dovish Fed statement. Overall, the December Fed meeting outcome was in line with expectations, so that thinking was based on more hope than reality or facts.
- In the short term, markets are driven by sentiment and human behavior, which are pretty difficult to predict, and not necessarily something you'd want to build your portfolio around.
- For most longer-horizon investors, the type of market volatility we've been experiencing is actually healthy in our view. It helps reset valuations before they get too out of hand and it can be a good opportunity to rebalance one's portfolio.
- Volatility like we're seeing is at the core of why we worry about risk management. Risk management is really an all-season activity in a process and definitely not something to just turn on when markets get scary and then turn off when they start going up again.

The full transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to a new episode Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton.

I'm your host, Richard Banks.

Ahead on this episode, putting market volatility in perspective.

Host/Richard Banks: Wylie Tollette, head of Client Investment Solutions, Franklin Templeton Multi-Asset Solutions, looks at the impact of sentiment on volatility short term and other factors driving it. Plus, new opportunity resulting from current market conditions.

Speaking with Wylie is Franklin Templeton's Jack Bailey. Jack, take it away...

Jack Bailey: Thanks Richard. Wylie, let's start with the impact rising [interest] rates are having on market volatility. The Fed [Federal Reserve] just announced another [interest] rate increase. I believe that's the ninth one since the tail end of 2015. They also lowered their projections for next year, 2019, from three hikes to two. What's your reaction to that and how does this factor into market volatility?

Wylie Tollette: You know, the nice thing about the current Federal Reserve is they're actually pretty good communicators. I know they used to have a history of sort of obfuscating what they were actually planning to do, but now they are pretty clear about what they're going to do and because of that, the market's largely been able to anticipate many of these recent rate increases, including the most recent one. And the increase was largely in line with expectations. Some investors were in fact hoping for more of a dovish statement from the Fed. I think that was based more on hope than reality and facts. So the markets reacted to some degree to that, but the Fed talked about the fact that there's sort of a balance of risks, both the potential for further upside as well as risks on the downside, and that those risks right now are pretty well balanced, but the underlying current economic data has been strong and justifies the existing rate trajectory. They did signal that they're going to be sort of potentially slowing down next year beyond where they had thought they were going to be several years ago. So economic growth is moderating, and that may allow them to slow the rate of interest rate increases. But overall, it was in line with expectations. I think that the volatility resulted from the dashed hopes of a few sort of incremental investors.

Jack Bailey: What else is happening in the markets right now that's driving market volatility apart from just this most recent rate hike?

Wylie Tollette: In the short term, really, markets are driven by sentiment and human behavior, which, as we all know, are pretty difficult to predict, and not necessarily something you'd want to build your portfolio around. In the long term, markets are driven by economic fundamentals and valuation. So, a lot of this recent market volatility has been driven by the news flow around trade conflicts between the US and China in particular, the continuing divergence of economic growth between different regions and sectors as well as speculation around rate hikes like we just talked about. And then, in the background, there's Brexit. England isn't a huge part of the global economy anymore. I mean, it's still significant, and Brexit is significant enough to worry about. Like many geopolitical topics, it changes on a daily basis with the news flow. Even if the underlying economic fundamentals are not that significant, the news flow can drive that volatility.

Jack Bailey: What should investors do in response to this volatility?

Wylie Tollette: Our starting point regarding that question—which is really the most important question that you're asking—is that strategic asset allocation aligned with a particular investor's time horizon, their risk tolerance and their projected obligations or liabilities—that's really where the discussion should always start. And for longer-horizon investors that most of us are, with reasonably predictable liabilities and cash-flow demands, this type of market volatility we've been experiencing is actually healthy. It helps reset valuations before they get too out of hand and it can be a good opportunity to rebalance back to your target range.

Jack Bailey: What opportunities or challenges do these changing dynamics create?

Wylie Tollette: Human behavior, many times, is the first challenge that we have to address. Seeing losses on your computer screen or your brokerage statement, that's never pleasant. We know that we feel the pain of losses about twice more than we experienced the pleasure of gains. That's just human nature. And so, the first challenge is not letting those behavioral biases get the better of us. So, in our opinion, the first thing not to do is to sell long-term assets that you're counting on for economic growth and for price appreciation. And we believe selling those long-term assets when prices are down is almost always a bad decision. As I mentioned, I think volatility provides the opportunity to rebalance your portfolio, potentially at better prices, so you can sell what's gone up and buy what's gone down. Liquid, stable assets in your portfolio, something I called defensible space, that's had a large opportunity cost for a long time with interest rates so low for so many years now for more than 10 years. The cost of holding liquid assets in your portfolio was large—the opportunity cost—but that's recently improved as short-term interest rates have increased. So, using this as an opportunity to perhaps establish some defensive space in your portfolio. Investors that have that defensible space—some short-term bonds and some cash in your portfolio—it's a great opportunity to take advantage of lower prices on equities.

Jack Bailey: Let's talk a little bit about risk management. The current market conditions and volatility—how do they impact your views on managing risk in portfolios?

Wylie Tollette: Volatility like we're seeing is sort of at the core of why we all worry about risk management and think about risk I would say that risk management is really an all-season activity. It's definitely not something to just turn on when markets get scary and then turn off when they start going up again. It's really best to think about risk management and establishing that defensible space that I mentioned before the fires begin. You know, establishing defensible space works best if you're doing it before the fire erupts—the same thing in your portfolios. So, that market volatility we've seen, it really provides the opportunity to sort of gut check your asset allocation, your manager selection, your overall risk tolerance to make sure it's aligned with your time horizon and your liquidity needs. And I think that this is a good reminder for many investors to go back to that strategic allocation, make sure it's consistent with your long-term goals.

Jack Bailey: You know, you mentioned, risk is not something that you turn on or turn off, but it's interesting, We hear people talk a lot and use the phrase “risk on” or “risk off” to talk about their sentiment with regard to the market. Is that just a shorthand that people use and maybe we shouldn't take it too seriously when we hear it, or are people missing the boat on it being an all-season activity as you call it?

Wylie Tollette: Yeah, it's a great question. I think you always have to think about the perspective of the particular investor you're listening to. In our role at Franklin Templeton, we're the part of the organization that invests across different markets and different asset classes. The multi-asset solutions team really thinks about this from the perspective of a multi-asset-class investor. So, we hold stocks, bonds, real estate, cash, commodities, inflation-protected assets—a wide variety of different assets in a strategic allocation. That's the lens through which we're looking at the world. So, when we hear risk aversion, for us, that again is always viewed through the lens of a long-term strategic asset allocation.

If you're an investor that's focused in a particular asset class—say global bonds or global equities or real estate or one specific asset class—it, in fact, could be a good time to buy or sell if you're just sitting in that particular asset class. And so many times when you hear a “risk on” or “risk off,” that has to do with the particular asset class or the lens that investor is looking through. Stepping back to a long-term strategic investor's perspective, like I said, “risk off” and “risk on” is always in the context of—what's my overall allocation, what's my long-term goal, what are my return objectives, and what liabilities am I going to really have to pay for, or what obligations am I planning to meet in the long-term with this, and what's the best way to take advantage of volatility? So, as I said, many times, what's a risk-off environment for a particular investor may actually be an opportunity for another long-term investor to rebalance their portfolio, to buy stocks that previously were perhaps getting too expensive. This is a chance to come in and selectively rebalance.

In the multi-asset strategies team right now, we have what we would call a balanced view of our forward-looking allocations. In other words, that means we're sticking with our long-term strategic asset allocation. Sometimes we have a slight overweight to stocks. Sometimes we have a slight overweight to bonds. Right now, we're sticking with an overall balanced position. So, we're neither long nor short our strategic allocation. We think that's a good position to be in given—like what the Fed said—there's a balance of risks on the up and the down. So now is not a great time, we think, to be strongly convicted one way or the other as to which direction the market takes going forward. If you're not strongly convicted one way or the other, your best choice is to stick with your long-term objective.

Jack Bailey: And speaking broadly about the markets and investor sentiment and behavior, as you were mentioning before, do you get a sense that there's more risk aversion creeping into markets these days?

Wylie Tollette: Yeah, certainly compared to where we were at this time last year—where there was significant optimism, the economy seemed to be hitting on all cylinders, we had a tax cut starting to impact it—and you sense that right now the short-term sentiment is more risk aversion creeping into the marketplace. You have to be cautious, though, because, like I said, one of those human behavioral biases I mentioned is, we tend to act a little bit like a pendulum, and maybe we go a little too far one way or the other. And so, while you could back away from risk entirely, we think that would be an overreaction, given that economic fundamentals are actually still pretty solid.

Jack Bailey: We've had several years where the market has been generally trending upward, you know, maybe not at the rate that everybody wanted it to trend upward, but it certainly has been going up for a number of years. And I know that got some people thinking okay, we're due for a correction or a downturn. In your view, do you think there is a downturn in front of us somewhere in the near-term, and if so, is there any way to prepare for something like that?

Wylie Tollette: There's always a way to prepare and in our opinion, the best way to prepare is to think about your long-term allocation, make sure you've got defensible space, some liquid assets to make sure you can meet short-term obligations, but it's very, very difficult for anyone to get it right coming all the way in and all the way out of risk at any given moment. Timing that correctly is almost impossible. I would add as well just like the Fed said, economic fundamentals are actually pretty strong. And there's a balance of risk going forward to the economy. The risks of it going down are perhaps offset by the risks that it might continue to go up, and the forward-looking picture is unclear. And when you're in that situation, I think the best thing to do is to stick to your long-term objectives.

Jack Bailey: Alright Wylie. Thanks so much for the time. We appreciate you talking with us and sharing your insights.

Wylie Tollette: Great. Thank you.

Host/Richard Banks: So that's it for this episode of Talking Markets with Franklin Templeton. We hope you enjoyed Jack and Wylie's conversation. If you did, and would like to hear more, why not check out our archive of previous episodes and subscribe on iTunes, Google Play, or just about any other major podcast provider. But for now, goodbye!

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