

Fear is Good

The point is, ladies and gentlemen, that fear, for lack of a better word, is good. Fear is right, fear works. Fear clarifies, cuts through, and captures the essence of the evolutionary spirit. Fear, in all of its forms...has marked the upward surge of mankind.

This may *almost* sound familiar. It is *almost* part of a speech made by bad-guy corporate raider Gordon Gekko (portrayed by Michael Douglas) in the 1987 movie *Wall Street* (written by Stanley Weiser and Oliver Stone), with one word switched. Gekko's now-famous speech was about greed, not fear. We disagree with Gekko, though – the key to buying low in the stock market is to use fear as an indicator, not greed.

If the recent stock market volatility is keeping you awake at night, take a look at the Chicago Board Options Exchange Volatility Index (“VIX” for short), measuring the implied volatility of index options for the Standard & Poor’s 500 index of large U.S. stocks. As market volatility increases, the value of options, often used as a kind of insurance to defray risk, increases as well. It is as if you could get an intraday quote for premiums on flood insurance – they likely would increase in stormy weather. Do not worry about the technical details – it is enough for our purposes to know that professional investors often refer to VIX as the “fear index.”

In the “upward surge of mankind,” fear may have kept us humans from being eaten by a predator on the plains of the Serengeti, but it is a deficient investment guide, leading investors to panic and sell at low prices. Option traders may be sophisticated compared to most investors, but they are human too and therefore prone to being confident when caution is warranted and cautious when confidence is warranted. VIX is a continuous measure of the presence of fear among these professionals.

Ned Davis Research correlated the performance of the S&P 500 index to the VIX index from the start of 1997, and the results are remarkable. The VIX index fluctuated roughly between a low of 10, signifying great complacency, and a high of 80, reflecting the intense panic in the financial crisis in late 2008. The VIX index has been at levels indicating a high degree of fear less than 17 percent of the time. The S&P 500 has gained 38 percent annualized in the presence of that fear. During the other 83 percent of the time, the S&P 500 *declined*.

“Man looks in the abyss, there’s nothing staring back at him. At that moment man finds his character. And that is what keeps him out of the abyss.”
-- Hal Holbrook as “Lou Mannheim,” *Wall Street*

Let us say that again – you could have reaped more than all the upside in the stock market over the past 13 1/2 years by holding stocks less than a fifth of the time, enhancing these high returns by earning interest on T-bills the rest of the time. Following the simple rule of only investing when investors are fearful, you held stocks at the exact bottom of the bear market in March 2009, at the exact bottom of the previous bear market in July 2002, and at the exact bottom of the market decline after the Russian debt default in 1998. In contrast, you would have been

clipping coupons on those T-bills when the bear market following the tech bubble started in early 2000 and when the bear market following the real estate/subprime bubble market started in October 2007. As “magic” indicators go, this record is startling, although, of course, past performance is no guarantee of the future.

Ah, but there’s a rub – you would have had trouble sleeping (or eating or maybe even breathing) during some of the 17 percent of the time you were invested in stocks. The collapse of Lehman Brothers? You were buying stocks the following Monday when everyone else was panicking, and you remained fully invested as the market continued to fall precipitously for another six months. September 11, 2001? You invested in stocks just three days previous, and therefore endured the full break downward in the market. Russian debt default in 1998? You held stocks during the majority of the accompanying market decline. Not as easy to imagine, but just as painful to actually live through, you were sitting in cash as everyone else was getting rich in the late stages of the aforementioned technology and real estate booms. Sounds great, but hard to do.

Therefore, we have a wonderful indicator, but with a problem – it is an indicator that no one realistically can follow, a road to riches only if you are unconscious. Any sentient investor, alert and attentive to changing conditions, would be likely to panic with everyone else in the collapses and to be cocksure with everyone else at the peaks. The record of the VIX index proves yet again that evolution, despite the upward surge of mankind, did not make us good investors.

Unless used as a contrary indicator, fear does not clarify, and the only thing it cuts through is your stomach lining. In the recent market decline, the VIX once again reached the magic fear level, indicating investors view the stock market with dread, frightened to take on any risk – and the historical record, which may not repeat, indicates the probabilities favor better times ahead. Successful investing requires discipline, training and experience. In investing, you need to resist human nature. *Wall Street* has a sequel coming out later this year, but the destructive impact of emotions on investing are even more enduring than Oliver Stone’s franchise.