Alley Company Quarterly Letter
The Return of Volatility

April 12, 2018

The stock market finished the first quarter of 2018 essentially flat, down by less than one percent.[1] For the "Rip Van Winkle" investor that slept through it, Q1 was mundane. But for the investor that is fixated on daily market movements, it was more of a rollercoaster ride.

During the quarter, there were *24 trading days* where the Dow Jones Industrial Average moved up or down by 250 points or more. By comparison, there were only six such trading days during all of 2017. Spikes in market volatility are not abnormal and one could also argue that the market was susceptible to a choppier period as daily volatility levels in 2017 were 40% lower than the long-term average.[2]

This recent bout of volatility has at times felt like a schoolyard game of "tug of war." On "down" days, the market becomes preoccupied with concerns such as global trade tariffs, the pace of Federal Reserve interest rate hikes, possible future regulation of technology companies, and the ongoing Mueller Russia investigation. Conversely, "up" days turn the focus back to a strong U.S. economy, global economic momentum, and the tailwind of tax reform. While there are always issues to be concerned about, markets ultimately separate out the "noise" and, in our view, investors should pay most attention to company-level fundamentals as the main driver of long-term value.

With stock prices fluctuating at an accelerated pace, a possible conclusion is that *risk* has increased, but is this the right conclusion? An accepted industry measure of risk is standard deviation (the variance or volatility of returns), so in this sense risk has risen according to the world of academia. Volatility, though, need not be viewed as a signal that risk has increased - all it really means is that the dispersion of prices has widened. **Where volatility can turn into risk is when knee-jerk decisions are made that undermine one's long-term goals and objectives**.

Warren Buffett has said: *"Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it."* Periods of market volatility can be an opportunity to "upgrade" one's portfolio by adding new companies that have become attractively priced.

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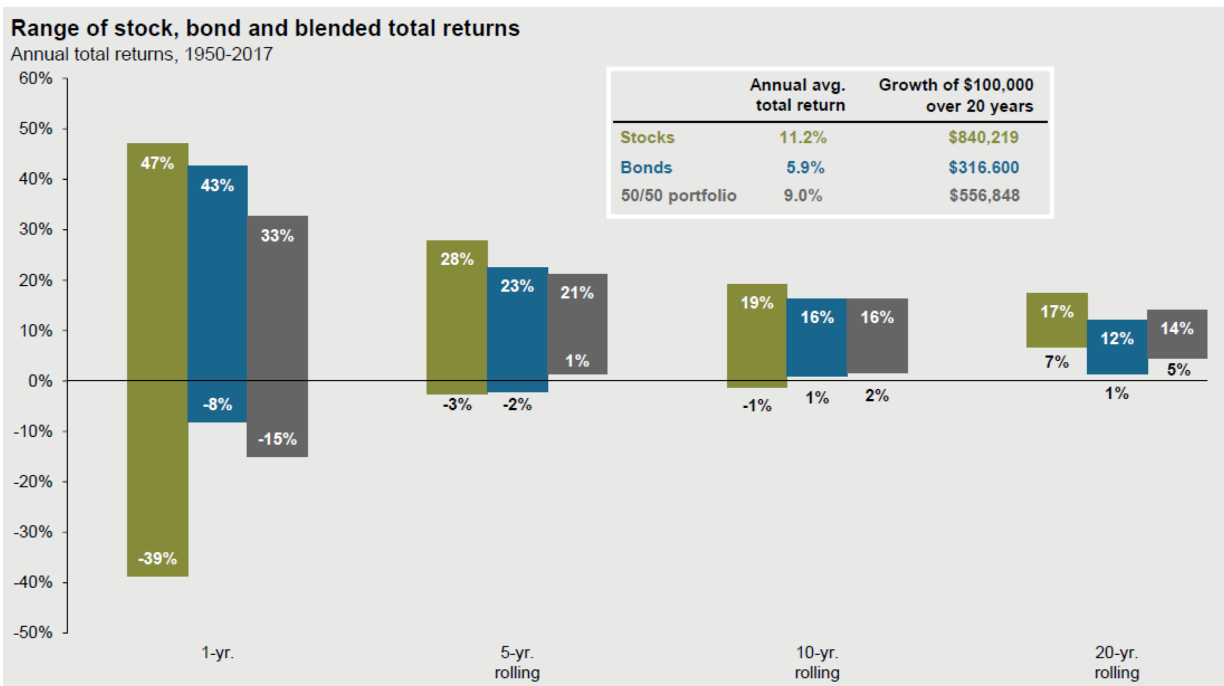
It can also be used to rebalance toward one's strategic asset allocation – essentially, adding to an asset class on weakness or trimming on strength. And, for money sitting on the sidelines, it can provide an opportunity to invest or dollar-cost average.

The age-old advice of "think long term" when it comes to investing can sound trite, but during times of market volatility it can be a virtue. Looking back over the past 67 years, we see in the chart below that for short periods of time – e.g. one year – stocks have exhibited high volatility with a range of returns of -39% on the low side to +47% on the high side. When time horizons are extended – e.g., five and 10 years – the range of stock returns narrows and, importantly, the downside is far less and actually comparable to bonds. At long time horizons – e.g. 20 years – stocks have a very compelling risk/reward profile with the *worst* 20-year rolling return being +7% annually.



Source: JP Morgan Guide to the Markets

Volatility is an inherent part of investing. Navigating it with a steadfast plan is crucial to earning satisfactory returns. According to a study by Dalbar Inc., the *average investor* has earned an annual return of 2.6% over the past 20 years. During this same period, the stock market has returned over 7.2% annually.[3] This suggests that all too often individuals push aside their long-term plan and react to volatility, albeit unsuccessfully.

The best way to succeed in a volatile market environment is to be engaged in an investment program that can be *understood and trusted*. This leads to sound decision making. At the core of an investment program should be an understandable investment philosophy. Alley Company's investment philosophy is to own high-quality businesses with long track records of success as the *centerpiece* of an asset allocation structure. We believe this is a sensible and an enduring approach to growing one's wealth. When an investment philosophy that stands the test of time is combined with an appropriate strategic asset allocation, one can become a bit more like Rip Van Winkle and sleep better at night.

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[1] The total return for the S&P 500 in the first quarter of 2018 was -0.76%.
[2] yCharts data on CBOE Volatility Index (VIX)
[3] JPM Guide to the Markets, Q2 2018. *"Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/17".*