



Investment Insights

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War, Peace, and the VIX

With international events, political wrangling, and the constant flow of economic news causing daily volatility in the investment markets, it's a good time to look at how all of this news can effect your investments. Although it seems like markets always have something to worry about, the pace of news and events seems to be greater than ever.

We have had many clients ask us recently about the potential impact on the markets of what seems to be the impending war against Iraq. This is a good example we can evaluate to illustrate how the markets tackle these types of issues.

The financial markets are excellent at factoring in potential outcomes of an event into the current situation. The market takes current information, and then looks forward and tries to determine the impact on business and psychology. In the case of the war on Iraq, the market participants have had plenty of time to run through scenarios and simulations to try to plan for what looks like a high-probability event. So as a general rule, any news that has been widely discussed and debated is already reflected in stock prices.

A theory that applies to this type of situation is called the Efficient Market Theory. In essence, this theory says that once information is publicly known, it is immediately factored in to asset prices. All participants, from individual investors to mutual fund managers, absorb the information immediately, and factor it into their decision-making process.

A frequent example centers around companies announcing quarterly earnings. It is not uncommon to pick up the newspaper and note that one of your companies announced poor earnings the night before, and then see that the stock is actually trading higher that day. Often, the market has anticipated a weak earnings report, frequently because the company warned the market by publicly "pre-announcing" the results weeks before. Thus, when the final results are announced, the market has already priced in that news and is looking ahead to indications of future earnings.

One place you can actually see the level of anxiety or complacency present in the market at any point in time is in a measure known as the VIX. The VIX (the CBOE Market Volatility Index) reflects the risk market participants feel. When the VIX is high (usually

considered to be above 30), the market is nervous, and is anticipating a big move in prices either up or down in the near future. Below 30 reflects more complacency, meaning the coast looks clearer for the short term. This past Friday, September 6th, the VIX closed at 40, and it has been above 30 since early July. Thus, you can see that the markets are aware of the potential for war and the risk involved, and is already pricing this into the market.

Yet even the markets are not perfect: unexpected events can catch the markets off guard and cause violent moves both up and down in the short run. For example, the 9/11 terrorist attacks last year were completely unanticipated. The reaction in the markets was huge (once they reopened). Should we have an event or outcome to an event that is not expected in the markets, the same type of volatility can occur again.

As financial advisors, we try to measure not only the chances of an event happening, but also what the market is anticipating will happen, and what the chances are that the real-life outcome will differ dramatically from the anticipated outcome. For us, it's not so much whether we'll go to war with Iraq (that seems to be almost a certainty), but whether we have as easy a time in 2002 as we did in 1991 (as the market seems to think right now). If this is Gulf War Part II, we should be ok. If this is Vietnam Part II, we could be in for some turbulent times in the investing world.

As an investor, one should always look past today's headlines and try to draw conclusions about how today's news might impact the economy weeks, months, and years from now. As a popular Wall Street saying goes, "Don't invest by looking in the rear-view mirror."

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