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How Responsible Are Machines for the Volatility Spike?

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After a decade of financially engineered profits and overleveraged balance sheets, we felt companies and financial assets were vulnerable to a negative exogenous shock. With that said, is it simply the severity of the current coronavirus shock that's leading to equity volatility like what we saw in 1987 and 1929? Does it explain the astounding evaporation of liquidity across markets? The level of daily yield changes in the AAA-rated fixed income markets this past week hasn't been observed in nearly four decades.

Volatility occurs when the market is exposed to developments it can't easily assess the potential economic impact of. We suspected that after a long period of tranquility and sanguinity, something would come along to knock markets off their perch, raising volatility markedly. However, the level of strain on the plumbing of our financial system, the shocking magnitude of price dislocations and the eye-watering levels of volatility suggest there may be other factors at play. Here are three:

1. Over the past 10 years, we have seen a systematic shift toward algorithmic trading platforms. Capital-intensive resources — people — have been replaced by capital-light machines. But rules-based trading platforms, while inexpensive and fast, don't collaborate with counterparties or peers. They lack the ability to ask questions such as, "Does this bid make any sense?"

2. We have seen tremendous growth in financial products designed to replicate beta cheaply. These products have provided investors with choice and created a price war, pushing fees in the asset management community almost to zero. Well, guess what? You get what you pay for! In our view, passive may be cheap, but what you save in costs, you probably pay for in hidden risk. Has the growth of rules-based and price-inelastic investment solutions added to widening bid/ask spreads, margin calls and forced selling? Don't worry. It's a rhetorical question.

3. A global savings glut and negative real rates over the past decade-plus have prompted investors to seek income in other ways. As a result, systematic volatility-selling strategies have mushroomed. These strategies are designed to harvest the volatility premium paid by investors seeking portfolio insurance. In simpler times, volatility was a statistic such as "assists" in a basketball game. In recent years however, volatility has become more like a player on the court— a product bought and sold by investors — distorting markets' primary risk gauge: Volatility is on the court in both up — and now down— markets.

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Every cycle produces a unique set of excesses, but the catalyst is often the same — the pursuit of risk premia. But risk premia aren't free. Investing may be simple, but it's also incredibly hard. When a financial asset disappoints, an MFS fundamental investor has a process: Focus attention, stress the model, talk to management, assess the ranges of outcomes (risk versus reward) and if nothing has changed the long-term thesis, consider buying more. If the thesis has changed, then we consider selling. Can a machine do that, when nuance, context, collaboration and common sense are required?

Tradeoffs are a big part of life — and of investing. But there are no shortcuts to risk premia and attempts to cut corners have made this crisis more difficult.

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