Measuring Fear in the Markets

- The most basic investor emotions are fear and greed. One measure of investor fear is the VIX, as outlined in this article.
- The VIX tends to spike during periods of great uncertainty. During such times, COMPASS believes investors should not allow their emotions to dictate their actions by abandoning their investment strategy and asset allocation.

Fear is a basic emotion that all human beings experience when feeling threatened or uncertain. Fear can be caused by many things, from being afraid of losing a loved one, to being fearful of the ancient Mayan prophecies that predict the end of the world. Interestingly, an investor can also experience (and measure) fear in the stock market.

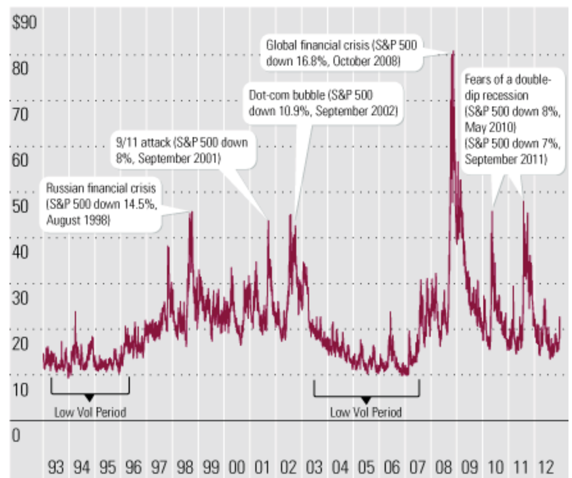
Fear in the market can be measured by the Volatility Index (VIX), also commonly known as the “fear index.” The VIX measures the uncertainty that investors feel about short-term market prospects. A period of high fear is characterized by higher uncertainty, higher volatility (stock prices swinging widely), and a higher VIX reading. On the other hand, a lower VIX reading occurs during less stressful periods because of lower uncertainty and lower volatility.

The image highlights the daily closing price of the VIX over the last 15 years. When there were sudden downturns that resulted in steep declines in the market, the VIX spiked sharply to reflect the uncertainties in the market. Examples can be seen during the Russian financial crisis in 1998, the 9/11 attack in 2001, and the dot-com bubble in 2002. More recently, the global financial crisis saw the S&P 500 decline by 16.8% in October 2008, causing the VIX to spike to an all-time high of $80. Concerns regarding a potential double dip recession in 2010 and 2011 also caused the VIX to rise. When times were good and the market grew complacent, the VIX was not as volatile. Instances of this can be seen throughout the 1990s, as well as during the period leading up to the global financial crisis from 2003–2007.

Why is fear so rampant in times of great uncertainty? It’s one thing to be afraid of what’s happening next in a stable market, but it’s a completely different story when you’ve just seen your portfolio shed 40% of its value and wonder what’s next. Investors understand that fundamentals advocate investing for the long haul, and avoiding market-timing pitfalls in the short-term. Yet they can’t help but be afraid, thinking about what would happen if they lost another 10% of their savings over the next month, next quarter, or next year. What if markets never recover and they never see that money again?

Investors who are faced with situations where they are fearful of market performance in the near future should take a step back and avoid making irrational investment decisions that may adversely impact their financial goals. Similarly, during calmer times, investors should not be lulled into a false sense of security and expect markets to only continue to rise forever. And for those investors saving for retirement, it is important to remember that short-term fear and volatility should not impact their decisions for the long term.

Daily Closing Price for the VIX



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. The S&P 500 index is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. The VIX is represented by the CBOE volatility index.