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Surviving volatile markets in 2016

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The threat of higher US interest rates, China's slowdown and Australia's sluggish growth have all contributed to rising market volatility in 2015. How can investors position themselves to generate higher returns in the year ahead, while managing risk?

An indicator of this year's higher volatility is the CBOE Volatility Index, which measures the expected movement of the S&P 500 Index in the month ahead. In August, the so-called "fear index" spiked to 28.3, its highest level since 2011. Although it recently fell to around 25, it remains historically high.

Australian stocks have been similarly volatile, with the S&P/ASX 200 Index's rolling 30-day average also spiking recently to a nearly 1.5 per cent change, well above its average of around 0.5 per cent a day.

According to BetaShares chief economist David Bassanese, volatility has trended up since 2014, with a key contributor being the market fretting over the timing and direction of planned interest-rate increases by the US Federal Reserve.

After numerous false alarms, most commentators expect the Fed to announce its first rate hike in nine years at its next meeting on 15-16 December, with only a gradual trajectory for further increases in 2016.

If past history is any guide, share investors should expect US stocks to drop in the three months following, but to bounce back within six months.

However, Bassanese warns investors to watch out for any signs of tightness in the US labour market and potential growth in wages.

"If wages and inflation in the US do pick up, all bets are off and the Fed can't sit back--it could raise rates at a quicker pace, which could have a quite negative impact on the market," he says.

"The other source of volatility in the market with the Fed rate rise is what happens with currencies ... Until recently, most people thought the Fed raising rates would lead the US dollar to rise and the Australian dollar to fall, so everyone's been pretty bullish on the US dollar. But if you look at history, in the last three Fed tightening cycles, the US dollar has actually weakened in the first few months post-hike."

China's slowdown has also rattled investors, with its position as the world's biggest resource consumer making it the main contributor to the recent mining sell-off.

For Australia, falls in coal and iron-ore prices have reduced the terms of trade to their lowest level since 2006, with even major miners such as BHP Billiton (BHP) and Rio Tinto (RIO) not immune to the bearish sentiment.

Despite the price plunge, surging export volumes helped the Australian economy expand by 2.5 per cent on an annualised basis in the September quarter, ahead of market expectations, although real net disposable income per capita shrank for the sixth straight quarter.

Managing volatility

Bassanese argues that the traditional approaches to managing volatility all have drawbacks for investors.

Doing nothing and "riding out the storm" is highly risky, particularly for those nearing retirement. Reducing risk by buying more defensive assets such as cash and bonds will reduce returns and increase longevity risk (the risk of outliving your assets), while attempting to time markets is also challenging, given that most investors tend to "sell low and buy high".

However, investors now have access to products such as the BetaShares Managed Risk Australian Share Fund (AUST), which attempts to cushion downside risk while still benefiting from market gains.

Glenn Rushton, executive director of Rushton Financial Services, says in volatile market conditions, investors should place greater emphasis on risk and be more focused on seeking a good "risk-adjusted return"--rather than simply a "good return".

He suggests investors reduce overall risk through such strategies as a highly diversified "market neutral approach," which could perform equally well in both rising and falling markets, with moderate volatility.

"The low correlation of this strategy to traditional long-only share investments can further reduce volatility in most investment portfolios, while providing valuable downside protection," he says.

For investors, the protection offered by such strategies could prove beneficial in 2016 and beyond, with little apparent sign of market volatility diminishing.