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Embracing market volatility

Recent market movements have caused investor nervousness, but this is not a time to worry. It is a time to think, to plan and, most importantly, to examine valuations. If you do these things, volatility can be your friend.

Volatility is never pleasant, but neither is it always negative. Downward market movements can be quite healthy and, in my opinion, the volatility we're currently experiencing falls into that category because a healthy correction is warranted.

For several months, experts have been calling for a pullback. They consider the TSX/S&P Composite Index gains of over 40% from its lows to be excessive. Pundits deem the markets to be over-bought because they rallied too fast. They've called for a correction so things can calm down and new money can enter the markets.

According to Credit Suisse, US money market funds are at 27% of market cap versus the long term average of 19%. Too gun-shy to get into the markets in March, many retail investors have been patiently waiting for signs that the markets have improved. They hold much of the necessary new money.

As this new money enters the markets, it should provide sustenance to support the current rally and drive stocks higher in the longer-term. However, these investors need a reason to start buying, and the most appealing motive is lower prices in the near-term. So, what will force prices down?

Fear will be a factor. It is a very powerful emotion that causes irrational behaviour. In the markets, fear drives nervous investors to ignore the principles of valuation. Instead, many react to even the slightest negative news and sell good stocks. This gives stout-hearted investors, who are focused on valuations, an opportunity to exploit those emotional decisions.

The CBOE Volatility Index has been fueling speculation of a correction. Used as the benchmark for market volatility, it is often called the "investor fear gauge". As the VIX hovers around the psychologically significant level of 30, some investors' fingers hover over the panic button.

But this is not a time to panic. A healthy correction is necessary for the markets to move forward and, when it occurs, investors need to be prepared with a strategy. For those who have been invested since March, volatility provides several options. They can take profits and re-balance portfolios; add to existing good quality positions on the dips; or do both.

For investors waiting on the sidelines, opportunities will be equally plentiful as quality companies trade at discounted prices. Because they are rebuilding portfolios, these investors should consider incorporating defensiveness by buying some dividend-paying stocks. Sustaining regular dividends and having them grow are also important indicators of a company's quality.

And the quality companies are there. Despite analyst expectations being low, third quarter earnings have been quite good. According to Credit Suisse, a net 72% of companies thus far have reported earnings above consensus, and they are predicting 29% U.S. earnings growth in 2010.

Many waiting buyers will lose patience and jump too soon but, because they are buying after stocks have already rallied significantly, they will only benefit

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others. Needless to say there will be plenty of sellers wanting to lock in profits and these sales will help propel prices downward.

Investors must disregard the market's manic-depressive behaviour and concentrate on buying solid stocks at the right prices. Whether you're buying a pair of shoes, a car or a stock: quality matters. If you can get a good deal, so much the better.

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