Management briefing: Market volatility

When counting the cost of stock market unrest, it pays to know which numbers to count

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On September 29 there was the biggest one-day point swing in the history of the Dow Jones industrial average, the key measure of America’s financial health. It fell by 778 points after the House of Representatives’ failure to ratify a $700 billion economic bailout plan. Indeed, the Dow’s 60 biggest point swings – with the exception of one day in 1987 – have occurred in the past 11 years, leading to suggestions that we are in an unprecedented period of market volatility.

Don’t be so sure. According to a report by G. William Schwert, Professor of Finance and Statistics at the Simon Graduate School of Business at the University of Rochester in New York State, such suggestions are “incredibly misleading”.

Point swings, or the Dow’s absolute scale, do not tell the true story. Professor Schwert argues that we should look at the change in the percentage value of the index. “This is how much money you would have left if you invested $100 at the beginning of the day,” he said.

When it was first published, the Dow measured 40.94 points. Now, it stands at about 9,000 points, down from a record high of 14,164.5 points on October 9, 2007. As the point value is higher, he contends, point swings tend to be larger. “A 900-point swing wouldn’t even have been possible until around 1980,” Professor Schwert said.

Looking at percentage changes in the value of the Dow, the figures, while not stable, are less dramatic. “While market volatility is high right now, it’s certainly not unprecedented. With the exception of the Great Depression of the 1930s, episodes of high volatility typically do not last for extended periods of time,” the professor said.

More than 50 of the 60 biggest changes in percentage terms took place before 1998, with only three occurring recently. This means that market volatility, taken in the wider context, is “actually remarkably stable”. Britain’s FTSE 100 index, which measures the value of leading blue-chip companies, shows that volatility now is similar to levels in the United States and to the late 1990s or early 2000s.

It is even comparable to 1973-74, the time of the first OPEC crisis, Professor Schwert said. While the financial services and housing markets are faring badly, other stocks, such as technology, which suffered after the dot-com crash in 2000, are comparatively stable.

Attempts to lower volatility artificially, for example through increased regulation of trading or taxes on trading, would be unwise, Professor Schwert said. He expects volatility to return to normal levels by the end of next year: “We’ve come through far worse than this. The disruption is real but there is not going to be a stinking long great depression.”