The Hidden Volatility Within US Equity Markets

If you've read or watched financial news lately, you've probably heard that the US stock markets are "overdue" for a 5% or more pullback, or possibly even a 10% correction. The stock market has been locked in "easy mode" for most of the year, with only brief pauses in a relentless uptrend. The S&P 500 finally, just barely, gave us the elusive 5% pullback, but has now quickly regained all the lost ground and is pressing for new all-time highs. So, was that it? Or was the 5% dip just a prelude for the elusive volatility that seems warranted as stocks surge despite crippling supply chain issues and the inevitable rise in interest rates?

2021's seemingly unstoppable uptrend will eventually end, but attempting to time an "overdue" correction is a dangerous game with a high opportunity cost. Counting the days since the last big correction is also based on the faulty premise, that stocks have only gone up this year. Underneath the placid surface of the broad market indices, most individual stocks have actually been quite volatile so far in 2021.

To illustrate, let's examine drawdown in the S&P 500 Total Return Index from Jan 1, 2021 through October 19, 2021. The largest peak-to-trough drop, or maximum drawdown (MDD), occurred from Sept. 2-Oct. 4. Considering the index is up around 22% even after this pullback, it's reasonable to say that there has been little volatility this year. Yet when we drill down into the underlying 504 constituent stocks, we can see that the average MDD through October 19th is -17.7%, more than three times greater than that of the S&P 500 Index.

The simplest explanation would be that the average MDD ignores market capitalization, as the S&P 500 is dominated by a handful of mega-caps. Yet these name brands have also seen far greater than -5% pullbacks, as the below table of the 10 largest S&P 500 constituents reveals.

Figure 1. Top 10 S&P 500 Constituents Maximum Drawdown 1/1/2021-10/19/2021

Ticker	Name	Maximum Drawdown
MSFT	Microsoft	-9%
AAPL	Apple Inc	-19%
AMZN	Amazon com	-15%
GOOGL	Alphabet Inc Class A	-8%
FB	FaceBook	-15%
TSLA	Tesla Inc	-36%
NVDA	Nvidia	-24%
BRK/B	Berkshire Hathaway-B	-7%
JPM	JPMorgan Chase & Company	-11%
JNJ	Johnson & Johnson	-12%

Source: Investors FastTrack

There is a similar discrepancy in the more volatile Nasdaq, which has an index-level MDD of -10.5% this year but an average constituent drawdown of -39%. How can we explain this disconnect? The answer lies in diversification, both at the sector level and individual stock level. Breaking the S&P 500 down to its 11 industry sectors, we can see that each individual sector fell over -5%, a greater decline than the cumulative index, with Energy posting the largest MDD at -17.7%.

Figure 2. S&P 500 Select Sector SPDR ETF Maximum Drawdown 1/1/2021-10/19/2021

Ticker	Name	Maximum Drawdown
XLE	Energy Select Sector SPDR ETF	-17.71%
XLB	Materials Select Sector SPDR ETF	-10.14%
XLY	Consumer Discretionary Select Sect SPDR ETF	-10.03%
XLK	Technology Select Sector SPDR ETF	-9.21%
XLU	Utilities Select Sector SPDR ETF	-8.95%
XLF	Financial Select Sector SPDR ETF	-8.42%
XLRE	The Real Estate Select Sector SPDR ETF	-8.27%
XLV	Health Care Select Sector SPDR ETF	-8.08%
XLC	Communication Services Select Sector SPDR ETF	-8.01%
XLI	Industrial Select Sector SPDR ETF	-6.98%
XLP	Consumer Staples Select Sector SPDR ETF	-6.15%

Source: Investors FastTrack

Diversification helped soften the volatility because the selling has taken the form of deliberate rotations from one sector into another, rather than the wholesale dumping of stocks that occurred during the COVID selloff in 2020. Therefore, the timing of each sector's MDD has varied since the money was put to work immediately rather than held in cash. For instance, investors cashed out Technology gains in February, rotating into more value-oriented stocks found in the Industrials and Consumer Staples sectors. These staggered ebbs and flows played out across all sectors, buffering the underlying volatility for investors who embrace diversification.

The takeaway from this exercise is that while indices are incredibly useful for gauging broad market sentiment and as a benchmark for portfolio performance, sometimes we need to look a little deeper, below the tranquil surface. Doing so reveals that, despite the smooth and steady uptrend, there has already been significant churn and realization of gains (as well as losses for tax-loss harvesting) within individual stocks. If you are still waiting on the sidelines to jump in on the "big pullback", it may have already passed you by.

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