In the aftermath of the Financial Crisis, the stock market returned nearly 250% from the trough in 2009, and experienced remarkably smooth upward trajectory. More recently, market conditions have changed and volatility has staged a comeback. What were the drivers of this historic return, how was this period unique in stock market history and what should investors consider going forward?

Introduction

In March 2009, at the height of the Great Recession, the Federal Reserve decided that monetary policy would be the best and perhaps only weapon available to help the U.S. avoid a depression and thus launched an audacious assault on interest rates in the hopes of stimulating the economy. The Fed’s plan was to directly lower short term interest rates through ZIRP (Zero Interest Rate Policy) and to pressure medium and longer-term rates lower by aggressively purchasing Treasuries through its QE program (Quantitative Easing).

The Fed was ultimately successful in reducing interest rates to multi-decade lows, and in so doing, also brought about an unprecedented confluence of extraordinary stock market conditions: extreme stock market returns, below average stock market volatility, and a sustained high level of stock correlations. While each of these conditions had occurred independently at different times in stock market history – the simultaneous persistence of all three conditions from 2009-2014 was unprecedented and created an environment that favored passive investing to a degree heretofore unseen. With the end of QE in Q4 of 2014 and the first Fed rate hike in Q4 2015, this confluence of extraordinary market conditions has broken down creating potential risks for passive strategies and underscoring the importance of active management.

Extreme Stock Market Returns

With the Fed pushing interest rates to record lows, fixed income investments were largely unattractive, so easy money led investors into higher-risk/higher-returning investment opportunities - with hard assets (e.g. real estate) and the U.S. stock market among the major beneficiaries. Moreover, the Fed was transparent about its intention to keep rates low indefinitely, implying that it would have investors’ backs (with what came to be known as the “Bernanke Put”) with markets benefitting until the economy could stand on its own two feet.

The Fed’s actions created an environment that became a rising tide that would lift all boats. Investor confidence was high. If markets were going to melt higher, why bother attempting to pick winners over losers – whether a specific company’s fundamentals or news flow was good or bad, everything was going up. Simply having equity exposure trumped individual stock selection. Investors flocked into equity markets with ETFs as the investment of choice.
In the wake of the financial crisis, companies were forced to respond to this new environment as well. Revenue levels were depressed and global GDP was forecast to grow at 3%, leading to 3-5% revenue growth for companies. In order to grow earnings, they were forced to cut costs – primarily by laying off workers, improving supply chain management, refinancing debt, and seeking tax advantages through offshoring and re-domiciling. The net effect was significant margin improvement and excess cash flow that was used to boost dividends and buy back stock. This “formula for success” drove double-digit earnings growth at a time when valuations were at or near historical lows.

The returns were stunning. During the six year period of 2009-2014, the average annual total return of the S&P 500 was 17% – a full 60% higher per year than the historic long-term (from 1950-2008) average of 10.6% per year. Over this extraordinary period, the cumulative return was 159%, or 76% above the long-term average for a 6-year period.

![S&P 500 Annualized Returns (CAGR)](image)

**Exceptionally Low Stock Market Volatility**

During this same time period, stock market volatility hit a sustained low. With the Fed depressing interest rates and seemingly controlling capital markets, investors felt comfortable owning equities and corporations were rewarded for investing excess capital back into their own stock – providing a steady and consistent tailwind that pushed the stock market higher. Whether you use an estimate of future volatility like the VIX (S&P 500 Volatility Index), a measure of actual historical volatility such the 60-day volatility on the S&P 500, or simply count the number of down days in the market – the period of 2009-2014 was notable for its relative calm. All the above mentioned metrics were well below historical averages and pushing all-time lows – despite all the economic turmoil of the period.

![S&P 500 60-day Volatility (1992 - 2014)](image)
**Sustained High Level of Stock Correlations**

Typically, even as the market advances or declines, not all stocks move together in the same direction. On a “good day” there is usually a wide dispersion—advancers and decliners within the overall move up. In a normal environment, different stocks react differently to economic news, global developments, industry events, and company specific drivers. Not true for this extraordinary time period. Stock correlations moved up and remained at high levels. As Fed actions drove investors into the stock market and companies plowed excess earnings into buybacks, stocks seemed to move up in lockstep as the market pushed higher. The market breadth or divergence of returns was very small. This condition was exacerbated as investors piled into ETFs. Whether the ETF invests in something as broad as the S&P 500 or in a narrower sector like the Biotechnology or Semiconductor Index, the effect is the same. All the stocks that comprise the ETF are bought together – thus increasing the correlations among stocks.

![Correlation Chart](source: Stralem & Co; Bloomberg)

**The Confluence of Extraordinary Market Conditions Breaking Down**

Despite the lengthy duration, the confluence of extraordinary market conditions that prevailed for nearly the entire period of 2009-2014, began to break down in Q4 2014. The Federal Reserve’s announcement that QE would be ending seemed to mark a turning point for equity markets especially when combined with concerns about record corporate margins, recession in China and the dramatic fall in oil prices. Suddenly investors started to question when the Fed would begin to raise rates and what it might mean for corporate fundamentals as well as at the macro level of the economy.

For the first time in years, in the spring of 2015, the “formula for success” was far more difficult to achieve and investors started to punish companies that reported poor earnings results and started to question excessive corporate valuations. While global GDP growth forecasts remained around 3%, with corporate margins for the S&P 500 at all-time highs, the opportunities to improve operations, restructure the balance sheet, or lower tax rates were by now significantly reduced. The buybacks continued, but with stock prices up over 200% from the bottom, the marginal impact was muted. The formula that had driven double-digit earnings growth for over five years was now yielding high-single digit growth, at a time when valuations were in the mid-to-high teens. The expectations bar was high and the margin for error was low, and companies that couldn’t execute were punished – creating a much more volatile stock market and a bifurcation of winners and losers.
The S&P 500 returned a mere 1.4% in 2015, breaking the trend of extraordinary high returns, with the strongest performance concentrated in a narrow group of stocks with clever acronyms (FANG: Facebook, Amazon, Netflix, and Google; and NOSH: Nike, O’Reilly Auto, Starbucks, and Home Depot). In Q1 2016, the market returned 1.35% - but not before experiencing a steep decline of over 10% through early February, followed by a robust recovery of almost 13% in the final seven weeks of the quarter.

The average 60-day S&P 500 volatility in 2015 rose to 15.2 – still below the long-term average of 16.2, but much higher than during the previous three years. In Q1 2016, it spiked to 18.9, well above average and a strong continuation of the recent trend higher.

The stock correlations in 2015 and Q116 (60%) remained stubbornly above the long-term average (49%), but are well off the record high levels (65%-75%) experienced in 2009-2011. These correlations are likely to remain elevated due to the ETF effect, but the recent widening of the dispersion of stock returns only serves to benefit active, fundamental investment management.

**What Does All This Mean for Active Investors**

The confluence of extraordinary market conditions that existed in 2009-2014 made it especially challenging for fundamentally-driven, valuation-sensitive active managers. If the rising tide lifted all the boats equally, then the advantage to discovering and investing in high-quality growth companies at reasonable valuations is muted. Nearly all stocks performed well regardless of fundamentals.

Now that the confluence of these conditions is abating, active management has an opportunity once again to outperform. Stock selection matters. High-quality companies with strong fundamentals, strong balance sheets and attractive valuations should be rewarded.

As the market works through the first quarter 2016 corporate earnings reports, the recent global macroeconomic challenges show no signs of abating. Select companies are executing very successfully and demonstrating the ability to navigate this challenging environment. Others are far less able.

This is the backdrop for what is typically referred to as a “stock pickers market” where the best active managers are able to differentiate themselves based on a superior process and stock selection capabilities. After six-plus years of passive management outperformance, the market may be signaling a change in the pendulum back to active management.

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