GARNET ASSET MANAGEMENT COMPANY, LP

# Wind Chill Factors

*by Glenn E. Atkins, CFA*

*Volatility: the difference of each data point (stock price or any other price) in the series from the average of all of them.*

I find it interesting in the winter when the weather forecaster talks about the wind chill factor. I'm not exactly sure what it is but it sure makes me shiver.

The securities market has its own wind chill factor called volatility. Volatility, in a way, refers to how the market feels versus the exact number of points it has advanced or declined. But in extreme conditions the market can feel much better or worse than the actual volatility shows.

Comparing recent market volatility (2000, 2001, and 2002) to high-profile periods in history, would you say that current volatility is higher or lower than in each of the following periods?

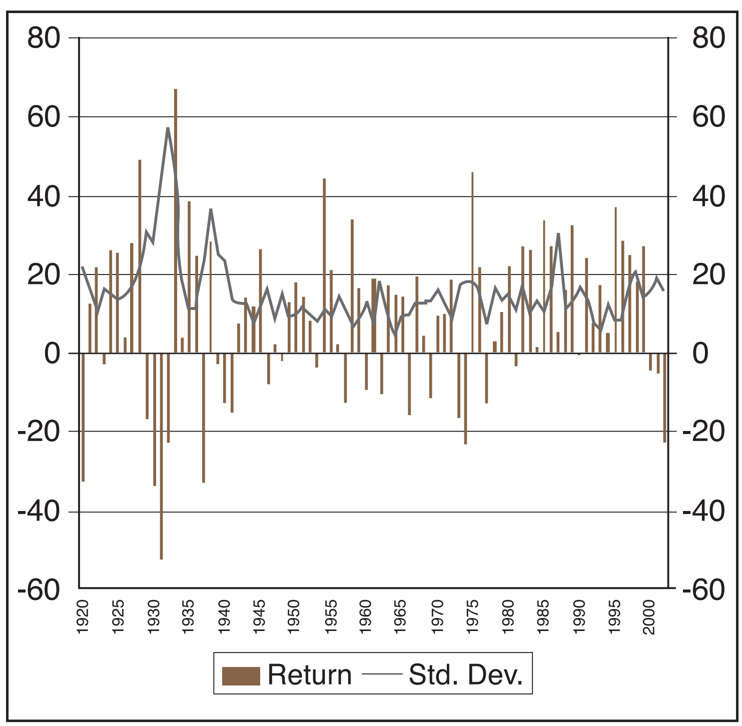
1) The period of the Great Depression from 1929 through 1933
2) The period 1937 to 1941, prior to and through the beginning of WWII
3) The period 1970 to 1974 during the oil/inflation shock
4) The year 1987 during the market "crash"

The market certainly seems to have been volatile over the last three years but in the context of history maybe it hasn't been as volatile as we think. Actually, current market volatility is lower than all but one of the periods above – can you guess which one? How about number three, the oil/inflation shock of the 1970's. Using the annualized standard deviations of monthly returns (i.e. volatility) on the Dow Jones Industrial Index, here's how the numbers look:

| Time Period | Volatility |
|---|---|
| 1929 – 1933 | 42.34 |
| 1937 – 1941 | 23.86 |
| 1970 – 1974 | 14.70 |
| 1987 | 30.59 |
| 2000 – 2002 | 17.08 |

***"the wind chill feels awfully cold right now"***

Average annual volatility since 1920 has been 15.58, making the recent level of volatility (17.08) about 9.6% higher than average. During the entire WWII period (1939 to 1945) the average volatility was 14.93. The greatest volatility occurred during 1932 at 57.91, when the market was down over 23% and near the end of the depression era.

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## Wind Chill Factors

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The lowest volatility occurred during 1964 coming in at 4.83 at that lull between the Cuban Missile Crisis and Kennedy's assassination and America's involvement in Vietnam beginning in 1965. The return on the Dow that year was 14.53%. The chart on page 2 shows the volatility and annual returns on the Dow since 1920.

This volatility thing is interesting to me for a couple of reasons. First, the wind chill feels awfully cold right now. Second, going into this project, I thought that current volatility would be historically high. It is slightly, but there have been many times during the last century when volatility was much higher. That was enlightening for me. This brings a couple of things to mind: I am aware that the volatility one actually experiences appears to be greater than volatility that one just studies from the past and it brings me to the comforting realization that, this too, shall pass.

## Quality of Earnings

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very high taxes on the remainder. Clearly, a dollar of such pension gain is not equal to a dollar of income from a company's operations.

How does a diligent investor gauge a company's pension plan accounting? First, consider the reasonableness of the company's long-term growth rate assumption. Compare the assumption to the plan's actual rates of return given in the 10-K filing as well as to long-term returns for stock and bond indices. Second, look for an unjustified increase in the rate assumption. This increase could be the tip that management may be manipulating the assumption to artificially boost earnings.

At present, finding information on defined benefit pension plans and their return assumptions requires some digging. But as the spotlight of analysts and the press continues to focus on the issue, companies may begin to report these items more prominently. As with any assumption that can benefit management in the short term at the long-term shareholders' expense, it is worth researching to see if it passes your own reasonableness test.



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