informed investor

evolution road wealth management

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Welcome to our latest edition of the Informed Investor newsletter.

As always, should you have any questions or would like some further information, please get in touch and we'll be happy to help.

How to stay focussed in volatile markets

Investing in markets means volatility. When done well, you are getting paid for taking on risk. So why is it that sharp drops in the market have such a visceral impact on us? We only have to go back to early February, when markets dropped 4.6% in a few days to recall such a time of alarming headlines and concerned conversations.

The first thing to say about February is that it was far from unusual. Since 1979, there have been 182 five day periods worse than the February decline. It happens, on average, every three months. It's about as frequent as a 29 degree day in Sydney. Warm, yes, but barely worth a comment. So why do we all feel this way when the markets fall?

The second thing to say, is that it was not unusual and moments of this ilk will happen again. With central banks commencing or stepping up their interest rate hiking cycles and unwinding quantitative easing (QE) stimulus, together with a divergence in monetary and fiscal policies, the result should be greater volatility.

Preparing for the inevitable

So the market just fell. You're reading headlines claiming billions of dollars of value have been wiped off the stock market in a matter of hours, days. You check into your account and see that your investments have also been affected. What will you do?

What most people do is act. They sell in fear. This is entirely natural, however, it is likely to be the wrong strategy. So what should you do?

For now, the best advice it to do nothing and to seek expert advice. That will feel all wrong. So let's unpack why that is and what to do to manage those feelings. To paraphrase a recent Wall Street Journal headline, 'The Share Market Isn't Being Tested, You Are'.

We need to feel in control

Nothing undermines a sense of control over your investments like a sharp and unexpected stock market fall. The immediate priority for many is to re-establish that sense of control. One of the most tempting means is by doing something, anything. This is linked to a deep-seated part of human nature and manifests in a desire to maintain the illusion of control.

In our daily lives, in order to act, we need to be confident in our ability to make an impact. In most cases this confidence can be classified as overconfidence, but without it we might not act at all. Being paralysed by indecision can be as bad as acting with overconfidence.

Search for meaning

You will probably have a very strong need to know why the market movement happened. It is more than mere interest. Needing to know is linked to the desire to

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act. Because jumping blind into a strategy feels wrong, we need an insight to give us enough confidence to act. Hence, the pressing need to find out why.

Actions have consequences

Adjusting your market exposure to suit evolving risk and return opportunities can be valuable. However, selling in fear is a powerful behavioural bias that costs investors dearly. If you were to sell in fear in each bear market (20% down) for Australian Equities since the early 1980s, and only return to the market some months later or once a recovery has started, then instead of a compound annual growth rate of 10%pa, you'd have achieved 8%pa. This is a costly bias.

One of many costly biases

There is a panoply of behavioural biases which help us get through the day. They are valuable mental shortcuts that help us act fast, handle information overload and find meaning. Occasionally these mental shortcuts do not serve us well. Investing is one such domain. If everyone is running out of a building, our instinct is to join them, no questions asked. This is a good example of the 'herding' bias - after all, the building could be on fire. However, this same bias in the investing context can be costly. Study after study has measured the costs of these biases and estimates range from 1% pa to as much as 6% pa.

What to do

- Recognise that markets are complex.
- Seek advice and consider the impact. Ask yourself - why am I making this decision? Is this investment part of an overall plan? What might go wrong? What does the evidence say?
- Record your decision and why you made it – by tracking your decisions, you can reflect on the evidence and adjust or confirm your approach.

Keep your eyes on the prize

Keep your eyes on the prize, whether that prize is growth, income, capital preservation or a mix. Bouts of short term volatility don't mean allocations have to change. Remember, this has happened before and will happen again. Selling in fear costs real returns in the long term. Financial advice is the best insulation from these and other biases waiting to erode our returns.

Source: Macquarie.

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