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FOUR LENSES FOR LOOKING THROUGH MARKET VOLATILITY

Market corrections are an inevitable feature of investing as economic conditions wax and wane from good to bad and back again, but they can be difficult times to navigate for investors. This is because investing is prone to being derailed by a range of common psychological biases that can trigger emotional decision-making. And emotionally made decisions can be hazardous to building long-term portfolio wealth. This article looks at some of the major psychological traps that investors can fall into and how advisers can help their clients to avoid them.

1. Don't overtrade or change strategies – it's bad for long-term returns

If 'time in the market beats timing the market' is a well-worn expression in investing circles, it is with good reason – it is one investing proverb that is totally borne out by the data. By analysing the transaction data of over 60,000 investors in a brokerage company during the 1990s, *Barber and Odean* (2000) found that the average after-cost return for investors who traded the most was 11.4%, which compared to 18.5% for those who traded the least, while the market return was 17.9%[1].

A material driver of the underperformance was the increased transaction costs associated with higher portfolio turnover, but overconfidence was also a factor. For those more active investors who take a keen interest in their portfolios and who also believe they can time market cycles, the evidence is far from compelling.

Investor takeaway: Decide on a long-term investment strategy with your adviser that is appropriate to your risk appetite and capacity for loss and then just stay the course. The evidence suggests chopping and changing is often a path to lower returns.

"The investor's chief problem – and even his worst enemy – is likely to be himself."

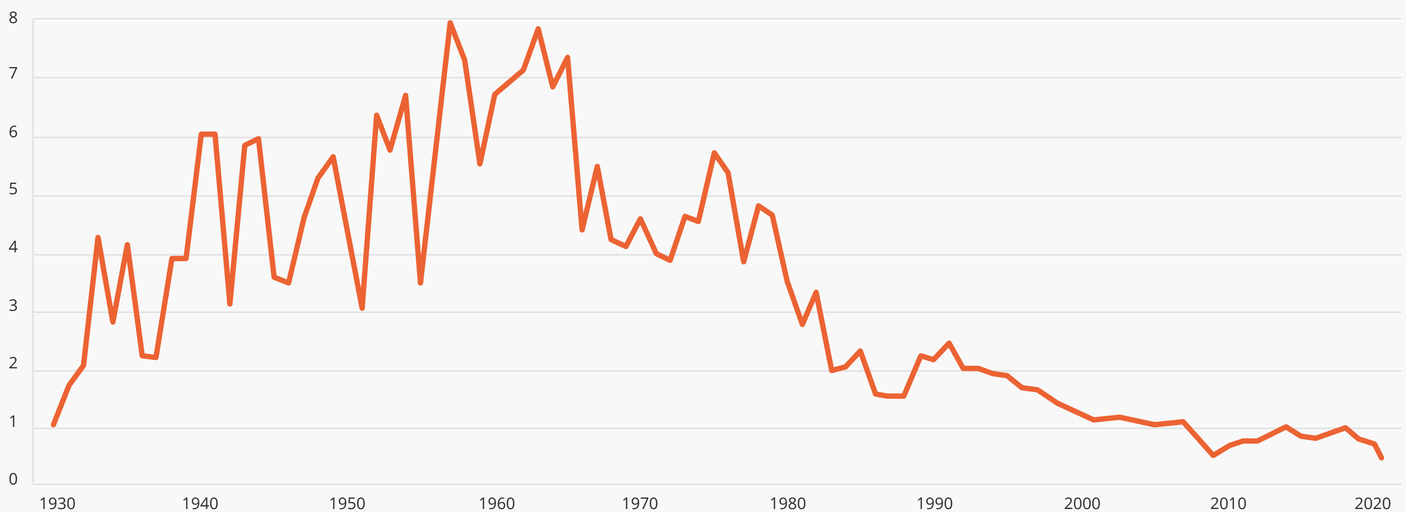
Benjamin Graham

2. Keep a longer-term time horizon

If time in the market is the secret to building long-term wealth, then short termism is one of the greatest risks to investors in the accumulation phase. Unfortunately, as soon as volatility strikes markets, hits the mainstream news or shows up in a quarterly performance update, investors' time horizons tend to shorten dramatically. Suddenly, short-term performance becomes virtually the only frame of focus. Even experienced investors can get drawn into short-term thinking. This combined with recency bias can prompt some investors to chase very short-term cycles in the market that may not be worth restructuring portfolios for in the longer term.

The problem is short termism is something of an innate human bias; studies from the field of behavioural finance have shown that most people would take £100 today over £200 in a year's time but would not take £100 in six years over £200 in seven, despite the fact the payoffs are identical. Neuroscientists have shown that completely different parts of the brain are responsible for valuing short and long-term monetary payoffs[2]. A fast-thinking, impulsive part of the brain connected to the dopamine system jumps at the idea of a short-term gain; but when the payoffs are further out, a slower-thinking part of our brain associated with calculation is brought in to work out a more rational choice.

Signs of short termism: shrinking holding periods of stocks (in years)



Sources: NYSE, Refinitiv
Note: Holding periods measured by value of stocks divided by turnover

The problem of short termism in markets has been steadily getting worse. Evidence from major stock exchanges highlights that investors have become more short-term over time. In the US, the average holding period of a share on the NYSE was around seven years in the 1960s; by June 2020 this had fallen to only six months. Short termism is not something that is confined to end investors either – even the focus of Wall Street analysts is overwhelmingly on forecasting company earnings for only the next one or two years.

Investor takeaway: The best way to get an edge in an increasingly myopic market, dominated by high frequency traders like hedge funds and day traders, is to take a longer-term view than the market.

"When an investor focuses on short-term investments, he or she is observing the variability of the portfolio, not the returns – in short, being fooled by randomness."

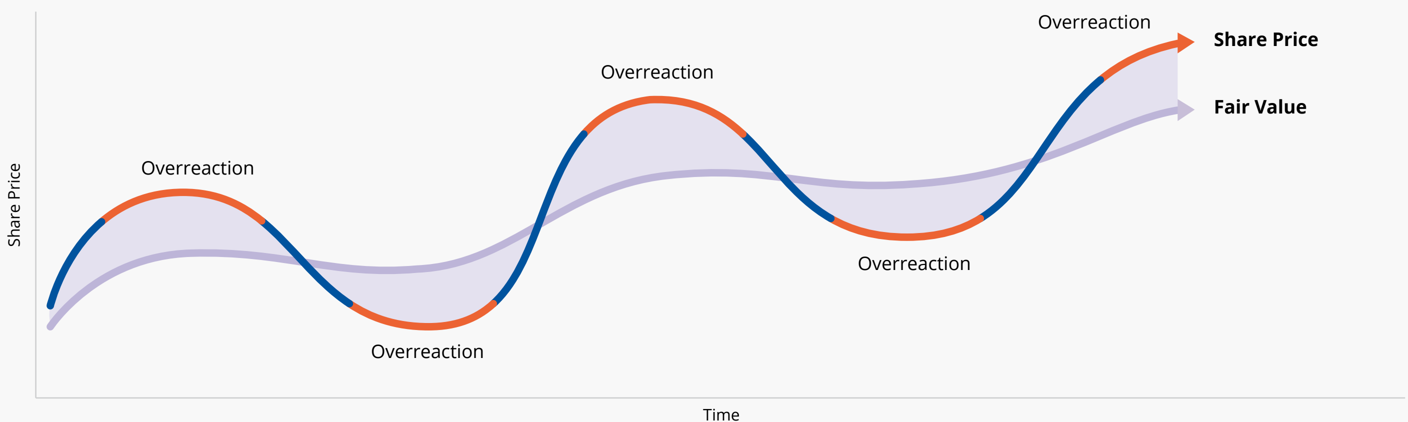
Nassim Nicholas Taleb

3. Don't blindly follow the herd

Given the strong herding instinct in asset markets, a bout of selling pressure can prompt some investors to question their own investment choices. Why are other investors selling? Do they know something I don't? Should I be selling too? The evidence suggests the answers to these questions can be surprisingly irrational. In his analysis of the 1987 stock market crash, *Robert Shiller* demonstrated that when investors were asked why they were selling, many said 'because everyone else was selling'.[3]

In stock markets, groupthink and herd-like reactions can cause share prices to move away from fair values and overreact in both directions. Share prices can get a little ahead of themselves when everyone is wildly optimistic and subsequently get oversold when everybody becomes much too gloomy. For longer-term investors in risk-aligned multi-asset funds, such times are a reminder that it is the outcome not the path that is critical in the patient accumulation phase of building a pension pot.

Herding can cause share prices to overreact in both directions



For illustrative purposes only.

Investor takeaway: Don't fall into the trap of copying other investors' moves, they may have completely different strategies with shorter time horizons, or they may be forced or distressed sellers.

4. Avoid buyer's remorse

History shows that different assets perform well at different times. However, there is a psychological pain known as buyer's remorse attached to investing in a chosen asset that subsequently performs poorly. Regret is one of the strongest felt human emotions and it is typically more pronounced the narrower and riskier the investment strategy. Buyer's remorse tends to be very high (and painful) for those investors with their entire portfolio allocated to a single asset class or equity sector fund when that asset or sector subsequently underperforms.

Investor takeaway: Multi asset funds can offer a simple but effective way of dealing with 'buyer's remorse'. By investing in a range of assets with different risk and reward characteristics, investors can avoid the binary pain associated with putting too much of their firepower in one asset only to see it fall out of favour.

"More money has been lost trying to anticipate and protect from corrections than actually in them."

Peter Lynch

Final thoughts

A long-term, risk-aligned investment strategy teamed with the discipline to stay the course can be a powerful combination in avoiding a wide range of potentially damaging emotional investing biases. The ability to focus on the long-term outcome and not become overly concerned about the path is a critical part of every patient investor's journey. Volatile times are when that discipline is most tested.

For investors in risk-profiled multi asset funds, a large part of dealing with market volatility is considered at the outset thanks to a risk-defined, mixed exposure to growth and defensive assets. Moreover, advisers who can model the impact of correction events on their clients' pension pots can put in vital groundwork to keep clients' emotions in check.

[1] Brad Barber & Terence Odean; "Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors", Journal of Finance, (April 2000).

[2] McClure, Laibson, Lowenstein & Cohen, "Separate neural systems value immediate and delayed monetary rewards" published in Science (October 2004).

[3] Robert J Shiller, 'Investor Behavior in the October 1987 Stock Market Crash: Survey Evidence'.

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