

LIVING WITH VOLATILITY

The current renewed volatility in financial markets is reviving unwelcome feelings among many investors—feelings of anxiety, fear and a sense of powerlessness. These are completely natural responses. Acting on those emotions, though, can end up doing us more harm than good.

At base, the increase in market volatility is an expression of uncertainty. The sovereign debt strains in the US and Europe, together with renewed worries over financial institutions and fears of another recession, are leading market participants to apply a higher discount to risky assets.

So developed world equities, oil and industrial commodities, emerging markets and commodity-related currencies like the Australian dollar are weakening as risk aversion drives investors to the perceived safe havens of government bonds, gold and Swiss francs.

It is all reminiscent of the events of 2008 when the collapse of Lehman Brothers and the sub-prime mortgage crisis triggered a global market correction. This time, however, the focus of concern has turned from private sector to public sector balance sheets.

As to what happens next, no-one knows for sure. That is the nature of risk. But there are seven simple lessons that individual investors can keep in mind to make living with this volatility more bearable.

1. Don't make presumptions.

Remember that markets are unpredictable and do not always react the way the experts predict they will. The recent downgrade by Standard & Poor's of the US government's credit rating, following protracted and painful negotiations on extending its debt ceiling, actually led to a rise in the prices of US Treasury bonds.

2. Someone is buying.

Quitting the equity market at a time like this is like running away from a sale. While prices have been discounted to reflect higher risk, that's another way of saying expected returns are higher. And while the media headlines proclaim that "investors are dumping stocks", remember someone is buying them. Those people are often the long-term investors.

3. Market timing is hard.

Market recoveries can come just as quickly and just as violently as the prior correction. For instance, in March 2009—when market sentiment was last this bad—the S&P 500 turned and put in seven consecutive months of gains. A little over a year after the low, gains had totalled almost 80 percent. This is not to predict that a similarly vertically shaped recovery is on the cards this time, but it is a reminder of the dangers for long-term investors of turning paper losses into real ones and paying for the risk without waiting around for the recovery.

4. Never forget the power of diversification.

While equity markets have had a rocky time in 2011, fixed income markets have flourished, making the overall losses to balanced fund investors a little more bearable. Diversification spreads risk and can lessen the bumps in the road.

5. Markets and economies are different things.

The world economy is forever changing and new forces are replacing old ones. As the IMF noted recently¹, while advanced economies seek to repair public and financial sheets, emerging market economies are thriving. A globally diversified portfolio takes account of these shifts.

6. Nothing lasts forever.

Just as smart investors temper their enthusiasm in booms, they keep a reserve of optimism during busts. And just as loading up on risk when prices are high can leave you exposed to a correction, dumping risk altogether when prices are low means you can miss the turn when it comes. As always in life, moderation is a good policy.

7. Discipline is rewarded.

The market volatility is worrisome, no doubt. The feelings being generated are completely understandable. But through discipline, diversification and understanding how markets work, the ride can be made bearable. At some point, value will re-emerge, risk appetites will re-awaken and for those who acknowledged their emotions without acting on them, relief will replace anxiety.

1 World Economic Outlook, IMF, April 2011

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