

Robson Consulting Group Pty. Limited

Volatile Times - Weathering The Storm

Market volatility is not new. Consider 16th century Holland, which under the grip of tulip mania, experienced tulip prices equivalent to houses. Or the Australian share market rising 88% in the 12 months to September 1987, while underlying profit growth over the same period was just 25%.

Why do markets experience bouts of volatility which exceed that justified by fundamental information flow? Experience and observation tell us that investors have a tendency to act irrationally. Emotions such as fear and greed can get in the way of good decision making based on fundamentals.

A distinctive feature of market psychology is the 'herd' instinct, that is, if others believe, it is safe also to believe. The herd mentality is fuelled by market commentators, with the short term focus of commentary at odds with the longer term investment horizon of most investors. Prices are driven up by irrational exuberance, becoming dislocated from fundamentals, while a 'this time it's different' attitude prevails. Investors do not want to get left behind.

Just as exuberance can drive the upswings, panic and fear drives the sell-off. Studies which have analysed the stock market crash of 1987 indicate that for many individual and institutional investors, no news event, other than news of the crash itself, precipitated their sell-off. For over-emotional investors, the age-old principal of 'buy low, sell high' is more often not followed.

Volatility and investment options

Risk and return is the inevitable trade-off with investing. If you are too aggressive you face the potential risk of losing a large amount of life savings that you may never recover in your investing lifetime. On the other hand, if you are too risk averse, you may not build sufficient capital growth required at some stage to generate a sufficient income stream in your retirement.

Those investors who ignored risk and volatility and dived into high tech stocks in the 'dot com' boom, believing 'this time it is different', lost a great deal of money. For those investors who rely on an income stream from their savings, the cost of volatility is even more real.

It is also worth highlighting volatility is only one indicator of risk and, as usual, stable past performance of a fund is not necessarily a guarantee of future stability. Unforeseen market factors can influence volatility. The fallout of the US sub-prime is a great example of this.

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Top strategies in volatile times

1. **Diversification** is the key to enhancing performance while at the same time reducing volatility in the overall portfolio. You can reduce portfolio risk by:

- diversify across asset classes
- within asset classes, diversify across investment styles

diversify across managers within the different investment styles as even the best managers do not stay on top forever

2. **Education** so that you have an understanding which prepares you for volatility. Remember that to achieve long term growth you will need to endure volatility in the short term, and that as long as the right investment option is chosen to begin with, you can ride out the bumps.

3. **Time in the market rather than timing the market.** Given that the strategic asset allocation accounts for up to 90% of the variability of returns, much effort goes into getting the mix of assets suitable to meet your long term goals. There is little evidence to suggest that market timing at the asset class level will add value over the strategic (long term) asset allocation over a full market cycle. It is best to avoid knee-jerk reactions in volatile times. Remember, you are investing to meet a long-term goal, not to avoid a short term loss. A shift from the strategic asset allocation can be detrimental to your returns and may increase real (rather than perceived) risks considerably.

4. **Capital protected strategies.** Investors approaching retirement need to continue to hold growth assets to grow their savings. However, they may be uncomfortable with the prospect of capital losses in volatile environments.

5. **Dollar cost averaging,** is a strategy involving the investment of fixed amounts of money into the markets at regular intervals, regardless of market conditions. Given it is difficult to predict the future, averaging into the market reduces the risk of investing at the top. Followed strictly, this strategy helps remove emotional decisions, making it easier to stick to a long term investment plan.

6. **Rebalancing.** Left alone, portfolios will drift outside desired asset class and investment manager ranges, especially in volatile times. The result is a portfolio which may no longer meet your needs in terms of risk and return. Rebalancing at regular intervals ensures the portfolios' risk and return profile is retained while removing decision making based on emotion. Rebalancing should typically occur during your portfolio reviews when conducted in conjunction with one of our experienced and professional advisers.

As always, it's important to seek professional financial advice. If you would like to explore the above strategies in more detail, please contact your financial adviser.

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