SURVIVING MARKET VOLATILITY

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Sudden and often severe stock market downturns are inevitable. On average, the S&P500 Index endures three 5% pullbacks and one 10% correction *each year*. Despite the media headlines ("End of the World", "This time it's different", etc.), temporary market downturns are hardly breaking news. In fact, they are about as common as dirt.

Far worse than any short-term underperformance, is the number of *pro-longed* periods (i.e. a decade or more) throughout history, where equities have not rewarded investors with the 'equity-like' returns they should expect given the risk assumed. In order to succeed, equity investors must be both mentally AND financially prepared for these realities.

However, inclusive of the previous bouts of volatility and underperformance, throughout history stocks have clearly been the best performing investment asset class versus fixed income and cash equivalents. Much of the historical data I've seen shows that equities have grown at approximately 9% to 10% per year over the long term. Sadly though, in practice many equity investors do not actually experience these stellar long-term results. It seems that too often investors react by abandoning their long-term strategy in a knee-jerk reaction to what often amounts to nothing more than short-term volatility. As the well-known investor and author Peter Lynch once wrote, *"The key to making money in stocks is not to get scared out of them."*

On the subject of 'investor behavior', I'm reminded of the survey results I'd heard about where *most* individuals who were polled said they believe themselves to be a better than average driver. Along the same lines of it being mathematically impossible for most people to be *better than average* – the facts simply don't square with *most* investors exercising the right behaviour when it comes to making their investment decisions.

Study after study has shown that investors experience results that are nowhere close to the actual historical returns achieved by the very market they are investing in. Many don't even achieve equity-like returns during a raging bull market. In concert with these findings (and perhaps – explaining the cause of them), actual sales flows consistently show that investors sell equities after a downturn and buy again *after* the inevitable rebound. Money typically pours into what has already been the hot stock or sector, chasing last year's top performers. Compounding this is the marketing onslaught of investment product manufacturers after putting up stellar performance results even they know they are unlikely to repeat. As a result, most investors consistently buy high and sell low, thus significantly detracting from what should otherwise be a winning investment proposition.

If equities provide a pivotal part of a long-term investment strategy, but our success is inhibited by human emotions like greed and fear, how do we close the gap between underlying investment returns and actual *investor* returns? My experience has shown that there are three keys to both surviving AND thriving during bouts of market volatility.

#1: Have a long-term investment plan

This might (or should!) seem obvious, but I'm amazed at how many investors, even those with serious sums of money, seem to take more of an ad hoc approach. The result is a mixed bag of often far too many holdings, with no apparent rhyme or reason as to what is held and why. In other cases, I've seen excessive exposure to one sector, or worse yet, one stock.

Rather than making it up as you go, start with a blueprint – the foundation for your long-term investment strategy. When working with a professional portfolio manager, this is referred to as an investment policy statement (IPS). Without going into great detail about all of the contents of an IPS, perhaps most important is the investor's asset allocation. This will pinpoint how much exposure you should have to stocks. A prudent amount of exposure can go a long way to helping you survive the inevitable downturns.

Your overall portfolio weight in equities should be determined by your investment time horizon (i.e. years before retirement). Many make the mistake of basing this on what they (with the help of a questionnaire) perceive to be their "risk tolerance". As a result I've seen young investors with many decades of investing ahead of them, holding guaranteed investment certificates (GICs) in their retirement accounts. This based on the fact that their personality type is generally risk adverse!? Whether or not you're a thrill seeker when you're young should have little to do with how your long-term investments are allocated. Further, I've seen older folks who have been prone to 'risk taking' throughout their working years, with far too much exposure to risky securities.

My general recommendation is that investors with a time horizon of ten years or more should allocate roughly 80% to 100% of their portfolio to equities. Those with less than ten years to retirement should take a more balanced approach, having approximately 40% to 60% in Equities with an offsetting 40% to 60% weight in fixed income type investments. Finally, for retirees (assuming a steady stream of *current* income is required) I suggest that *no more than* a 30% weight in the stock market is prudent, with the remainder in fixed income and cash equivalents.

While these are guidelines only, taking such an approach should allow all investors - regardless of their stage in life - to survive market volatility. The younger investor can stomach the downturns, knowing that they have at least a decade or more to recover. For these investors, underperforming markets should be viewed as nothing more than a temporary buying opportunity. To quote Sir Winston Churchill, *"Never let a good crisis go to waste".*

For the retiree, they too will have a prudent level of exposure to the impact of market downturns. They can rest at ease knowing that *"this too shall pass",* because the lion's share of their portfolio (more than 2/3rds) should be immune from the economic woes. The fixed income portion provides them with just that – a fixed income, while the cash allocation should be enough to safely fund at least a year's worth of income (more on this in a future article).

Overall portfolio performance for all of the above can be enhanced by rebalancing on a systematic basis, selling from the outperforming asset class and adding to the temporary underperformer. In this sense, such a strategy will not only allow you to survive but also thrive in the face of market volatility.

#2: Know the difference between investing and speculating

I see many market participants who think they are investing when they are really doing nothing of the sort. Often unbeknownst to them, they are really making big bets or speculations on what amounts to little more than a gamble and a pipe dream – while confusing this with actual investing. To those folks, I'd suggest they consider taking their money to Las Vegas where at least they'll be able to enjoy some nice weather.

Investing should be confined to a diversified portfolio of solid businesses; those with a proven and long-term history of actual profitability. To paraphrase what one investing guru so eloquently stated: *"don't buy crap!"*

Owning a portfolio consisting exclusively of good quality companies (i.e. with actual earnings) allows you to sleep at night during volatile times. Further, knowing that you own quality businesses can give you the confidence to buy more when market volatility results in temporary miss-pricings.

#3: Don’t be your own worst enemy

Before you hit the panic button during times of extreme market volatility, remember that there are two sides to every trade. For every share sold during a panic driven sell-off, there is an offsetting buyer of those same shares. Who would you rather be when prices are temporarily low and investors are panicking - the buyer or the seller?

Of course prices could go lower. However history has proven time and time again that the downturns are always temporary. Therefore bear markets provide a buying opportunity for those who are willing to take a contrarian approach. Remember – the ‘herd’ is always wrong! Regardless of whether prices go up or down in the near term, the smart money maintains a long-term perspective, buying stocks on the cheap during bouts of panic selling.

In closing, the following is one of my favorite quotes from Warren Buffett:

> “If you expect to be a net saver during the next five years, should you hope for a higher or lower stock market during that period? Many investors get this one wrong. Even though they are going to be net buyers of stocks for many years to come, they are elated when stock prices rise and depressed when they fall. This reaction makes no sense. Only those who will be sellers of equities in the near future should be happy when stocks rise. Prospective purchasers should much prefer sinking prices.”

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