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Volatility: 10 key messages for investors

FIONA GRAY financial planning

Independent Financial Advisers

Equity markets can experience bouts of volatility due to a variety of reasons. Here are 10 key messages and supporting data, plus quotes from well-known investors that can be used to help ease concerns when markets become volatile.

10 THINGS TO REMEMBER WHEN VOLATILITY STRIKES:

- Volatility is a normal part of long-term investing
- Long-term investors are usually rewarded for taking equity risk
- Market corrections can create attractive opportunities
- Avoid stopping and starting investments
- The benefits of regular investing stack up
- Diversification of investments helps to smooth returns
- A focus on income increases total returns
- Investing in quality stocks delivers in the long run
- Don't be swayed by sweeping sentiment
- Active investment can be a very successful strategy

1. VOLATILITY IS A NORMAL PART OF LONG-TERM INVESTING

From time to time, there will inevitably be volatility in stock markets as investors react to changes in economic, political and corporate environments. As an investor, your mind-set is critical. When we are prepared at the outset for episodes of volatility on the investing journey, we are less likely to be surprised when they happen, and more likely to react rationally. By having a mind-set that accepts that volatility is an integral part of investing, investors can prepare themselves to take a dispassionate view and remain focused on their long-term investment goals.

"The first rule of investment is 'buy low and sell high', but many people fear to buy low because of the fear of the stock dropping even lower. Then you may ask: 'When is the time to buy low?' The answer is: When there is maximum pessimism."

Sir John Templeton

2. OVER THE LONG TERM, EQUITY RISK IS USUALLY REWARDED

Equity investors are rewarded for the extra risk that they face – compared with, for example, bond investors – by higher average returns over the longer term. It is important to remember that risk is not the same as volatility. Asset prices fluctuate more than their intrinsic value as markets over- or under-shoot, so investors can expect price movements to drive opportunity. In the long term, stock prices are driven by corporate earnings and have generally outperformed other types of investment in after allowing for inflation.

"You pay a very high price for a cheery consensus. It won't be the economy that will do in investors; it will be the investors themselves. Uncertainty is actually the friend of the buyer of long-term values."

Warren Buffett

3. MARKET CORRECTIONS CAN CREATE ATTRACTIVE OPPORTUNITIES

Corrections are a normal part of bull markets; it is normal to see more than one over the course of a bull market. A stock-market correction can often be a good time to invest in equities as valuations become more attractive, giving investors the potential to generate above-average returns when the market rebounds. Some of the worst historical short-term stock market losses were followed by rebounds and breaks to new highs. (See Chart 1.)

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

Peter Lynch

4. AVOID STOPPING AND STARTING INVESTMENTS

Investors who remain invested benefit from a long-term upward market trend. When investors try to time the market and stop-and-start their investments, they run the risk of denting future returns by missing the best recovery days in the market and the most attractive buying opportunities that typically become available during volatile times. Missing out on just five of the best performance days in the market can have a significant impact on an investor's longer term returns. (See Chart 2 and Table 2.)

> "Everyone has the brainpower to make money in stocks. Not everyone has the stomach. If you are susceptible to selling everything in a panic, you ought to avoid stocks and mutual funds altogether."

Peter Lynch

5. THE BENEFITS OF REGULAR INVESTING STACK UP

Irrespective of an investor's time horizon, it makes sense to regularly invest a certain amount of money in a fund; for example each month or quarter. This approach is known as cost averaging. While it doesn't promise a profit or protect against a market downturn, it does help investors to avoid investing at a single point in time, lowering the average cost of their fund purchases. And although regular saving during a falling market may seem counterintuitive to investors looking to limit their losses, it is precisely at this time when some of the best investments can be made, because asset prices are lower and will benefit from a market rebound.

> "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die of euphoria."

Sir John Templeton

6. DIVERSIFICATION OF INVESTMENTS HELPS TO SMOOTH RETURNS

Asset allocation can be difficult to perfect as market cycles can be short and subject to bouts of volatility. During volatile markets, leadership can rotate quickly from one sector or market to another. Investors can spread the risk associated with specific markets or sectors by investing into different investment buckets to reduce the likelihood of concentrated losses. For example, holding a mix of growth assets (equities, real estate and corporate bonds) and defensive assets (government and investment-grade bonds, and cash) in your portfolio can help to smooth returns over time. Spreading investments over different countries can also help to bring down correlations within a portfolio and reduce the impact of market-specific risk.*

7. INVEST IN QUALITY, INCOME-PAYING STOCKS FOR REGULAR INCOME

Sustainable dividends paid by high-quality, cash-generative companies are attractive during volatile market conditions, because they can offer a regular source of income when interest rates are low and there are few income-paying alternatives available. High-quality, income-paying stocks tend to be leading brands that can perform robustly throughout business cycles thanks to their established market share, strong pricing power and resilient earnings. These companies typically operate in multiple regions, smoothing out the effects of patchy regional performance. This through-cycle ability to offer attractive total returns makes them a valid cornerstone for any portfolio.

8. REINVEST INCOME TO INCREASE TOTAL RETURNS

Reinvested dividends can provide a considerable boost to total returns over time, thanks to the power of compound interest. (See Chart 3.) To achieve an attractive total return, investors need to be disciplined and patient, with time in the market perhaps the most critical yet underestimated ingredient in the winning formula. Regular dividend payments also tend to support share price stability and dividend-paying stocks can compensate for the erosive effects of inflation.

9. DON'T BE SWAYED BY SWEEPING SENTIMENT

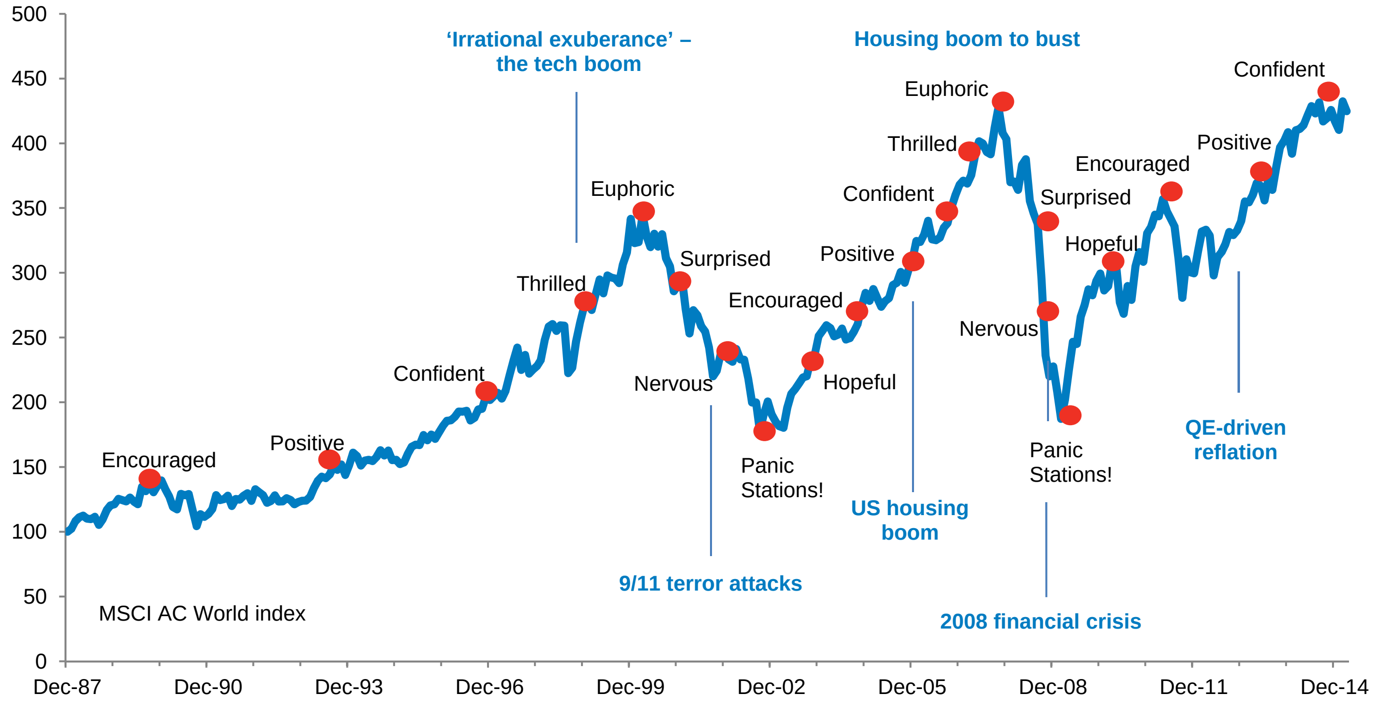
The popularity of investment themes ebbs and flows – for instance, technology has come full circle after a late 1990s boom and 2000s bust. Overall sentiment to emerging markets tends to wax and wane with the commodity cycle and as economic growth slows in key economies like China. As country- and sector-specific risks become more prominent, investors need to take a discriminating view, since a top-down approach to emerging markets is no longer appropriate. But there are still great opportunities for investors at the stock level, as innovative emerging companies take advantage of supportive secular drivers like population growth and expanding middle class demand for healthcare, technology and consumer goods and services. The key point is not to allow the euphoria or undue pessimism of the market to cloud your judgement.

LOOKING THROUGH VOLATILITY

Historical data can provide useful context that helps investors to both look through volatility and take an unemotional, long-term approach to their investments.

These charts and tables provide compelling evidence for a long-term approach, showing, for example, why with an approach of stopping and starting investments over time, you can run the risk of missing out on some of the best periods of returns.

Chart 1. How emotions can lead you astray



Source: DataStream, April 2015

Table 1. Strongest quarters generally outnumber the weakest ones (table for period Q4 1987 to Q1 2015)

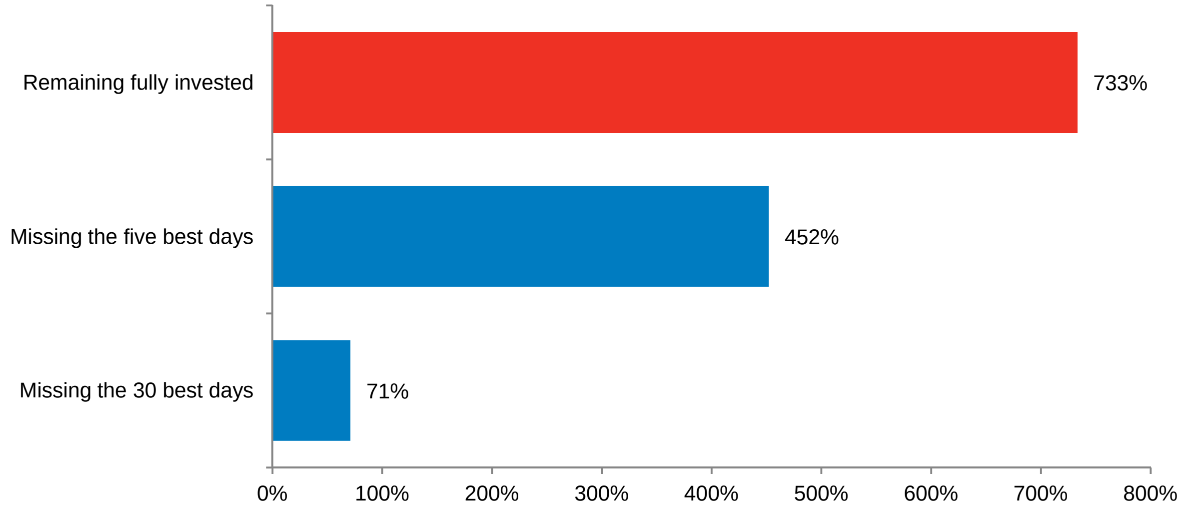
	Number of quarters with drawdowns of 10% or greater	Number of quarters with gains of 20% or greater
CAC 40 (TRI)	54	108
DAX (TR)	63	107
FTSE 100 (TR)	30	105
Hang Seng (PI)	69	104
Nikkei 225 (PI)	101	69
S&P 500 (PI)	43	104

Source: DataStream, April 2015

TIME IN THE MARKET BEATS TIMING THE MARKET

Inertia can be a positive force once the decision to invest has been made: missing the best days in the market can have a significant impact on your overall investment return.

Chart 2. Impact of missing the 30 best days in the S&P 500 (1988-2014), US$



Source: DataStream, Fidelity, January 2015

Table 2. The impact of missing five or 30 of the best-performing days over the long term

	Total return for the entire period 31/12/1987 to 31/03/2015	Total return minus **five best-performing days**	Total return minus **30 best-performing days**
CAC 40 (TR)	1,063%	624%	74%
DAX (TR)	1,097%	654%	68%
FTSE 100 (TR)	999%	640%	141%
Hang Seng (PI)	981%	457%	-1%
Nikkei 225 (PI)	-11%	-46%	-87%
S&P 500 (PI)	737%	455%	72%

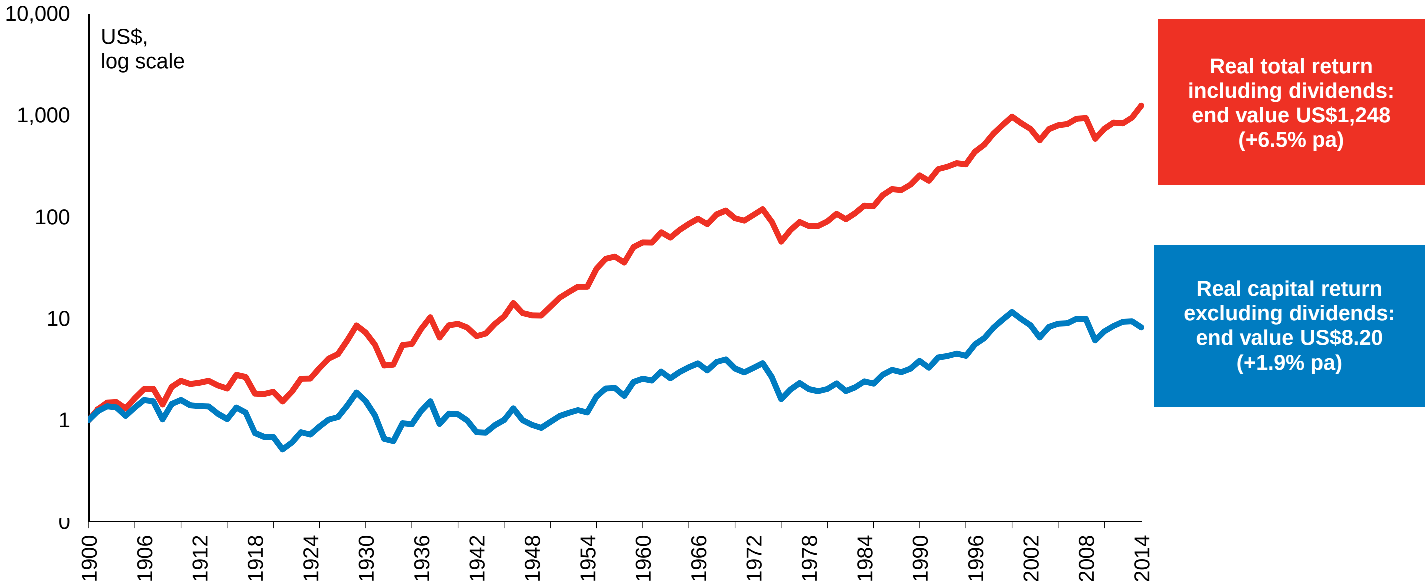
Source: DataStream, April 2015

Table 3. The best three-year and five-year periods of return between 1987 and 2014

	Best return in a three-year period	Up to end date	Best return in a five-year period	Up to end date
CAC 40 (TR)	175%	1999	260%	1999
DAX (TR)	141%	1999	230%	1999
FTSE 100 (TR)	89%	1997	168%	1999
Hang Seng (PI)	293%	1993	342%	1993
Nikkei 225 (PI)	106%	2014	84%	2013
S&P 500 (PI)	111%	1997	220%	1999

Source: DataStream, January 2015

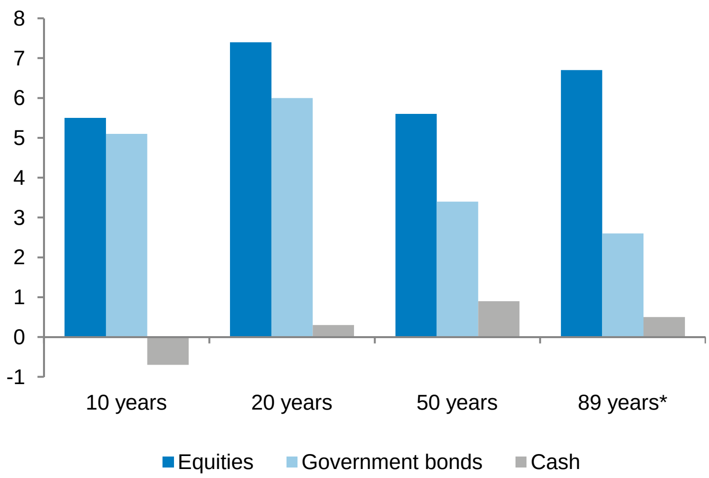
Chart 3. The power of compounding



Source: DataStream, May 2015

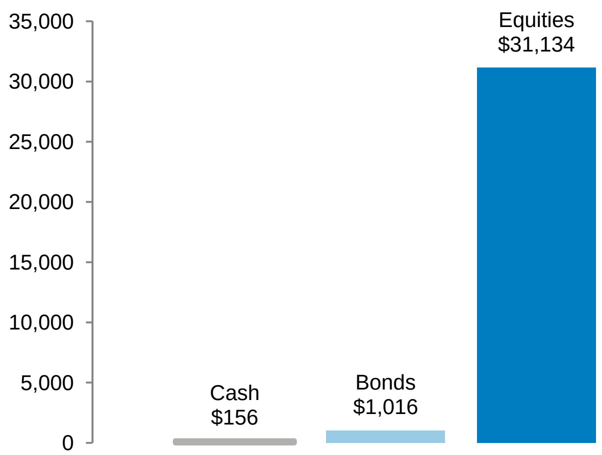
Over the long term, equity risk is rewarded:

Chart 4. Real US investment returns by asset class (%pa)



* Entire sample. Source: Barclays Equity Gilt Study 2015

Chart 5. Value of US$100 invested at end of 1925, as at the end of 2014, with gross income reinvested (US$ in real terms)



Source: Barclays Equity Gilt Study 2015

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