A STRATEGICPOINT WHITEPAPER

Preparing For Market Volatility

Protect Your Portfolios and Support Your Financial Future

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Stock market pullbacks come in a variety of flavors. There can be dips (< 10% loss), corrections (between 10- 20% drawdown), and finally bear markets (drops of 20% or more). Typically the size of the correction relates to the root cause of the selling. The market will act differently if the drawdown is tied to a poor economic environment, such as recession, credit crisis, bubble bursting. Those events usually cause the drop in stock prices to be deeper and to last longer. Corrections that are more event driven, such as the debt ceiling crisis in 2011 or the COVID-19 pandemic in 2020, usually do not last as long nor drop as much, IF they do not lead to a major economic reaction. Finally, the severity of a pullback is partially controlled by whether the markets overall have been sporting the face of a bull or a bear. In other words, all down markets aren't created equal and an investors reaction to each should not be either.

Sharp rallies work the same way… they aren't always driven by fundamentals in the economy or sudden attractiveness in stock prices. Like downturns, there are triggers and contexts that allow them to fade or flourish.

Investor Behavior in Volatile Times

The variety in volatility doesn't change how any sharp movement actually makes investors feel– lousy or elated! Those feelings can often drive poor decision making, since investing is often as much emotional as it is rational.

Since 1994, research firm Dalbar has been conducting an annual survey called *"Quantitative Analysis of Investor Behavior"* which compares the annualized return for the S&P 500 index versus the average stock fund investor. According to Dalbar's 2022 quantitative analysis of investor behavior report, the average equity fund investor returned 18.39% compared to the 28.71% registered by the S&P 500 for the 12 months ending Dec. 31, 2021. The findings are consistent with previous years.

The reason for such abysmal performance isn't that individual investors pick poor funds, but rather that they purchase and sell at precisely the wrong time, usually as a result of reacting to either fear or greed.

You have probably experienced this yourself: when stocks make new highs, you tend to suffer from overconfidence, making it hard to trim gains or reduce risk. But as soon as downside volatility grips markets, your anxiety level creeps up, leading you to want to sell.

Fear and Greed

Fear and greed are totally understandable; we all experience them. You'll probably recognize yourself in the following rationales investors often assert:

Fear (markets falling):

1. **"I can't afford to lose this money!!"** This statement is true if you need to spend most of your money now, resulting in realized losses from forced selling. But most people spend down their portfolios, gradually enabling them to weather good times and bad.

2. "**Ahhhh! I am down $20,000 (or some equally large number) this month."** Nominal losses feel larger than percentage losses, because it is easier to wrap your head around a dollar figure than it is to calculate what a percentage point means. But if $20,000 represents a very small percent of your portfolio, as large as the figure might feel, you are highly likely to see offsetting moves of that magnitude in the opposite direction in the future. We often feel the loss of
$20,000 much more than we appreciate a $20,000 gain.

3. **"I can't go through 2008 all over again!"** Do not fall prey to what behavioral finance professors call "Recency Bias": using your most recent experience with something negative and forecasting that out as the baseline for something in the future. True, it took the markets a very long time to recover from the 2008 financial crisis. But not all recoveries from bear markets take that long. The average recovery is 20 months, according to JP Morgan Asset Management. It is also important to remember that the US stock market goes up on average 70% of the time, which means that the longer portfolios remain invested, the better chance you have of making respectable profits.

Greed (markets rallying):

1. **"Oh my gosh, I am missing out!"** Watching markets take off while your portfolio is languishing in cash or other low risk alternatives can be agonizing. At some point, usually quite far into the recovery, you can't stand on the sidelines anymore and dive in and end up chasing returns when markets are very expensive.

2. **"It is different this time."** Rising markets make us feel good – and rich. It's called the wealth effect and can occur when any asset (stocks, real estate, or personal businesses) increases in value. The more wealth you have, the more risk you may be willing to take. In fact, the wealth effect feels so good that you may become convinced that it is different this time, and timing doesn't matter. It does. There is no guarantee that markets will keep rising.

3. **"I am pretty good at this."** Rallying markets can also make you feel smart, as you give yourself credit for selecting stocks and funds that are going up. What is often forgotten is that investing is an extraordinarily humbling pursuit. No one is spared – even long term experienced professionals. Approaching investing with the attitude, "What if I am wrong?" is helpful at keeping overconfidence at bay.

Financial planning means taking a hard, realistic look at what you really want and can expect out of your financial life, and then putting together steps to manage your expectations and keep yourself on track.

Panic-Proof Your Portfolio

Even if you aren't jumping in and out of the markets, it is good to panic-proof your portfolio. It helps you to stay calm and focus on what really matters: your future. *Here is what to do:*

Step 1: Develop a Comprehensive Financial Plan

(not an investment plan – that comes second).

Financial planning means taking a hard, realistic look at what you really want and can expect out of your financial life, and then putting together steps to manage your expectations and keep yourself on track.

Plans can be short term or long term. For those starting out and building wealth, your goals may involve establishing a business, buying a house, saving for college, and negotiating your career choices. For others approaching retirement or living in retirement, your focus may be on identifying retirement lifestyle goals, creating a long term care plan, developing retirement income strategies or focusing on wealth transfer.

Once the plan is established, the key is to check your plan first before making any major investment changes. Good financial plans have built in shock absorbers which allow you to handle normal market volatility. If you can confirm that you are on track to meet your goals, you are less likely to make sudden, impulsive moves in your portfolio. And if your plan is slightly behind target, you can look to choices unrelated to investments - such as remaining in your job another year, buying a slightly smaller house, or spacing out those big vacations – before feeling forced to sell into a bear market.

Step 2: Develop an Investment Plan

Your investments are designed to support your goals. They are not an end in and of themselves. Investments need watching and potential action to ensure that you are positioned so that your financial plan has the best chance of success.

Your investment plan should begin with an **outline of what you are trying to accomplish**. In doing so, it should incorporate your risk tolerance, including your time horizon for needing to access your money; your feelings about volatility (the ups and downs of the market); and your willingness to accept losses. Only after your investment goals have been properly addressed can you successfully manage your money.

Next, **build and implement an asset allocation plan** that allows you to periodically rebalance your accounts. Asset allocation divides your money among equities, fixed income, alternatives and cash and should not be static. You need to maintain a level of risk that is consistent with your tolerance and then adjust your asset mix to allow for varying levels of volatility and uncertainty in the markets. It is important to keep portfolio models broadly diversified within asset classes and between asset classes to avoid introducing unpredictable levels of risk. A well-diversified investment portfolio is better able to withstand whatever blows the economy delivers and cushions you against unexpected market risks you can't control.

In order to select your desired individual holdings, you should **utilize independent and unbiased research**. Headlines, tips and TV are poor market indicators and sources for what to buy. **Set up a careful screening** for possible funds or positions to hold that will allow you to monitor their performance. Screening can include such factors as active vs. passive, risk components such as standard deviation or beta, relative valuation and correlations, etc.

Practice risk diversification. Each holding you select should have an economic story behind it. If interest rates are going up, you may want a fixed income position that can protect you from rising rates. If you feel the economy is headed into a recession, then concentrating on sectors that perform relatively well during periods of low or negative economic growth could be the best choice. And feel free to avoid asset classes altogether that carry too much risk. Good diversification does not mean you need to hold a bit of everything.

Once your portfolio is created, you should **regularly take stock of what you own.** Does the reason you bought the fund or security still hold true? Has it performed up to expectations under the economic circumstances? If not, why? When a particular holding no longer holds promise, prepare to get rid of it. And look to replace it with a holding with greater potential.

In constructing changes, **make moderate – not manic – portfolio shifts**. Market corrections can turn around fast and rallies can fade quickly. Pulling back or adding to equities a little at a time allows you to test your thesis as to whether the bull or the bear will continue. If you are wrong, you haven't risked too much in terms of underperformance to the upside or the downside. If you are right, you can always add to the position or sell more.

A well-diversified investment portfolio is better able to withstand whatever blows the economy delivers and cushions you against unexpected market risks you can't control.

Getting Help for Panic-Proofing Your Decisions

And finally, **if you can't do it alone, find someone to help**.

Developing an effective investment management strategy that allows you to take advantage of growth periods and limit risk during volatility is not easy. It requires dispassion, discipline and experience. If you are no longer comfortable assuming this major responsibility or are not sure that your current broker/advisor is delivering what is necessary, then hire a professional who will help you take control of your financial life. Do your homework and select a firm that, as a fiduciary, will put your goals and best interest above all else and will design an investment strategy to best help you meet your personal financial goals.

Contact us for further information or an opportunity to review your personal financial situation.

Email us your questions:
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