PSG Wealth

DEALING WITH MARKET VOLATILITY

"Volatility is not the enemy of the long-term investor. That investor's response to volatility is." – Josh Brown

Reacting to market volatility based on a short-term period of discomfort can be compared to driving your car while looking in the rear view mirror – it doesn't work too well.

MARKET VOLATILITY – A CLOSER LOOK

When we have a look at the FTSE/JSE All Share Index over the last 18 years, the following observations are quite insightful:

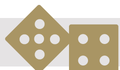
- Approximately 48% of the largest weekly gains occurred within a month of one of the worst weekly losses.
- Approximately 66% of the largest weekly gains occurred within three months of one of the worst weekly losses.
- The top 1% of largest weekly gains made up just over a third of the total return earned over the past 18 years (when we take the effects of compounding into consideration).
- The point is that the more time a long-term investor spends out of the market, the greater the risk of missing that crucial 1% becomes.

WHAT MARKET SELL-OFFS MAY SIGNAL

What complicates the situation faced by investors is that those abnormally high returns seem to occur more frequently after sharp market sell-offs – the very reason most investors flee the market. Then investors buy in again at higher prices in fear of missing further gains, locking in their losses. This is such a common occurrence that market participants actually coined a term describing the situation: 'being whipsawed by the market'.

But what if a sharp market sell-off is an omen for even worse things to come, let's say an event like the Global Financial Crisis (GFC)? Investors who sold out during the first dramatic 10% fall of that event averted a significant part of one of the worst market crashes in living memory.

MANAGING YOUR RISK



Considering all of this, the question becomes: How do I manage the risk of being whipsawed while also managing the risk of being exposed to another GFC-type event, without the use of a magic crystal ball? The answer is actually quite simple: phase in your investments. Phasing in places investors on a comfortable middle ground between being fully exposed to the market and idly sitting on the sidelines.

To illustrate how a phasing-in strategy can help you navigate uncertainty in the markets, we applied the strategy to the three most volatile market periods on the JSE during the last 18 years. We made the assumption that after experiencing a 10% drawdown, the investor implemented a phasing-in strategy over six months. We compared this to a buy and hold strategy and a strategy where the investor also sells out after a 10% drawdown but waits six months before returning to the market. The proportion of our investor's portfolio that is not invested in the FTSE/JSE All Share Index earns 9.5% p.a. in a money market investment.

Here are our results:

Strategy results after 1 year (27/11/1998 to 26/11/1999)			
	Buy and hold	Phase-in	Wait and buy in
Annualised return	46.16%	25.41%	16.32%
Standard deviation (risk)	22.50%	18.64%	15.84%
Risk adjusted return*	2.05	1.36	1.03

Strategy results after 1 year (14/09/2001 to 06/09/2002)			
	Buy and hold	Phase-in	Wait and buy in
Annualised return	12.76%	-5.26%	-14.90%
Standard deviation (risk)	29.61%	19.27%	17.10%
Risk adjusted return*	0.43	-0.27	-0.87

Strategy results after 1 year (26/09/2008 to 02/10/2009)			
	Buy and hold	Phase-in	Wait and buy in
Annualised return	-0.49%	13.02%	12.55%
Standard deviation (risk)	40.28%	21.12%	16.20%
Risk adjusted return*	-0.01	0.62	0.77

*Units of return received for each unit of risk taken.

Data Source: FE Analytics, weekly total returns on the FTSE/JSE All Share Index from 28 September 1998 to 28 August 2015. The annual return earned on cash is assumed to be 9.5%.

The first two tables provide a good example of where the market fell and recovered dramatically. Investors who reacted to the initial volatility were whipsawed, making the buy and hold strategy the winner. Notice the phase-in strategy provided a good middle ground compared to staying in and completely getting out of the equity market.

The last table covers the GFC time period, here the phase-in strategy proved to be highly effective in both moderating risk and delivering a positive rate of return in one of the most chaotic years in equity markets. Investors who stuck to a buy and hold strategy saw their equity portfolios fall in excess of 40% before recovering.

A PHASE-IN STRATEGY HELPS TO NAVIGATE VOLATILITY

As illustrated, following a phase-in strategy during bouts of market volatility places investors in-between the extremes of dealing with violent equity market swings and waiting in cash (with the possibility of being whipsawed). In the absence of a magic crystal ball allowing you to see into the future, following a phasing-in strategy is arguably one of the more prudent approaches to deal with market volatility. After all, long-term investing is about time in the market, not about timing the market.

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