Sit tight and don't be tempted by your biases

Market volatility and how to train your brain

Morningstar Investment Management
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Roné Swanepoel
Business Development Manager
Morningstar Investment Management
South Africa

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South Africa

For Financial Advisors and their Clients

The pilot's famous answer, when asked about his job, is, "Hours of boredom punctuated by brief moments of terror". This applies perfectly to investing, with the brief moments of terror being the rise and fall of markets. We could argue that we have just lived through one of the worst nine-month periods in history, not only for stocks but also for bonds and even more so for the much loved 60/40 (60% equities, 40% bonds) portfolio.

At this point in the market, investors may feel the need to understand every headline and the immediate impact it can have on their investments. And as we devour every article and/or watch every daily, weekly and monthly drop and rise in our investment portfolio, it becomes extremely important to know and acknowledge our behavioural biases.

What is worse – action or inaction?

Our minds take shortcuts every day when we make decisions. Like deciding to stick to a more familiar brand when buying an item. Usually, these shortcuts are for the better, they help us react quickly and help us manage the thousands of decisions we have to make every day.

There are times, however, when mental shortcuts are not helpful and tend to lead us astray, and that's when they become biases. What is a bias? Behavioural biases are irrational beliefs or behaviours that can unconsciously influence our decision-making process.

Markets have been brutal and it might feel like they are only going one way, and that is down. Taking action seems like the only rational decision to make. A common bias is called the ***Action Bias***, and is best explained by the sentiment of "well, at least I tried." This common consolation can be comforting and justified in many decisions, but not in all circumstances.

In some situations, it can be better to do nothing. The chart below shows the effect of moving to cash during a market downturn, using the Global Financial Crisis as an example.

- An investor who capitulated and moved to cash during the Global Financial Crisis would have ended with an investment portfolio of $160 096
- An investor who stayed the course would have ended with an investment portfolio worth $523 740

The difference equates to $363 644.

Source: Clearnomics, MSCI, Federal Reserve. Data as at 31 August 2022. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

In our minds, it hurts less to try something and lose, compared with doing nothing and losing anyway. During times of market volatility, if investors don't calmly think about the appropriate course of action and give in to action bias, it can make losses objectively worse despite feeling subjectively better. It is important to acknowledge that inaction is also an active decision.

Investors are inherently loss averse, meaning we hate losses more than we love gains.

One of the most well-known and often-cited behavioural biases is "***Loss Aversion***", and it too can be especially prevalent during market volatility. A 20% portfolio loss feels a lot more intense than a 20% gain for many investors and experiencing a loss generally feels twice as bad as gaining the same amount feels good.

This strong emotional reaction to losses and the need to "do something" can cloud our judgment during times of volatility and it is critical to acknowledge that losses are a part of a well functioning market. If markets never experienced losses, they wouldn't be risky, if they weren't risky, they would get really expensive, when they get really expensive they experience losses.

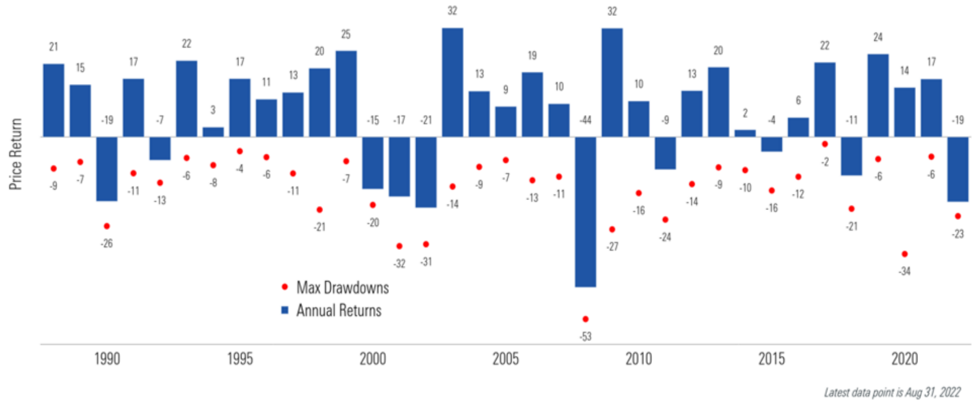
Learn to accept constant and guaranteed turbulence

Over the last 20 years, the average return for the S&P 500 and the All Share Index has been about 11% and 15% in rand terms[1]. Investing our hard-earned money in the stock market would be a lot simpler if we could rely on earning 11-15% every year without any volatility. But that is not the reality, throughout our investment horizon we will have to endure constant and guaranteed volatility.

Historically in both local and global markets, every year has had a "moment of terror" or drawdown and the chart below looks at the S&P 500 annual returns in the blue bars and the maximum drawdown of each year in the red dot. The maximum drawdown shows the movement from the highest peak of the market in that year to the lowest point.

[1] Source: Morningstar Direct; annual returns to end August 2022 averaged.

This chart shows that every single year of the 35 years had a maximum drawdown, while only 10 of the 35 years ended the year in negative territory.



Source: Clearnomics, MSCI. Data as at 31 August 2022. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

The four most expensive words in investing are likely to be "this time it's different"

During a boom, greed dominates. After the crash, the residual emotion is fear. If we look back to March 2020 it was the most volatile month since the Great Depression. An overwhelming amount of headlines read, "this time it is different", this was a pandemic, unprecedented times, markets would take years to recover, if they would ever recover. But, it was the fastest recovery we saw in stock market history.

During the sell-off in 2020, we reached a bottom in the market on the 23rd of March 2020. Historically it has taken the market about two years to recover from a drawdown of this magnitude. This time it happened in 149 days and at the end of August 2020, the market had already reached new highs.

Now that we look back, it seems obvious that the market would recover.

Hindsight is 20/20

Many events seem obvious in hindsight, this is called ***Hindsight Bias***. This bias tends to occur in situations where we believe (after the fact) that the onset of some past event was predictable and completely obvious, whereas in fact the event could not have been reasonably predicted. Identifying when things really are different and when the collective madness of the crowd is in full force is the difference between sitting out a market rally or participating in it.

In an article by Morgan Housel, he speaks about how important it is to remember that most of our lifetime investment returns will be determined by decisions that take place during a small minority of the time. Most of these periods come when everything we thought we knew about investing is thrown out of the window.

We all know to expect things like market volatility and inflation, but the emotions we feel while they occur can be even more dangerous than the market movements themselves.

Carefully consider both sides of the argument

Learning to embrace the downturns is easier said than done. We tend to seek out information that supports our beliefs, such as that the stock market will never recover, rather than seek information to the contrary. This is ***Confirmation Bias*** in action.

Let's consider an investment example of confirmation bias. It is December 2015 in the midst of Nenegate, the finance minister had just been fired, the 10-year bond yield had just hit a record high of 10,4% causing a sell-off in the bond market and the rand depreciated to more than R16/$.

You feel strongly that South-African bonds are set to experience significant losses, and the rand will continue to weaken, the economy is on the brink of collapse. You seek out every news headline and/or research that confirms your belief and you plan to move your fixed-income holdings to cash as a result.

Right before you make the change, your financial adviser shows you the probability distribution of historical bond yields and points out that South-African government bonds are offering attractive value at this point in time. When presented with this data, you say to yourself, "This is crazy. This would never happen" and you move ahead with changing your portfolio.

What happened in the next two years, between January 2016 and March 2018? South-African government bonds returned 15,23% annualised while cash returned 7,45% annualised over this period.

Remember to consider both sides of the market noise and movements when reading the news or looking at your investments. It might seem like the only decision is to move to cash during times of market volatility, but as we’ve shown above, the other side of the argument proves much more prudent.

Switch on autopilot and sit tight

For investors, it is critical to acknowledge these biases and make good decisions in volatile times. Making big changes when there has been no change in your time horizon, circumstances or needs can be detrimental to your long-term financial plan. Stay on autopilot during the turbulence.

When stress and anxiety are high, it’s easy to give in to our biases and let them cloud our better judgments. Research shows that understanding our biases can help us spot them in our decisions which can add immense value to our financial plan over time.

When you find yourself questioning your investments, and being down and out about the market, set up some time to speak to your financial adviser, who will be best placed to paint a realistic picture for you of what is really transpiring in markets and what action – or rather inaction – would be best suited to your unique investment needs.

+ t: (0)21 201 4645 + e: MIMSouthAfrica@morningstar.com + 5th Floor, 20 Vineyard Road, Claremont, 7708.