Volume 31 //

Acuity

The greatest wealth is **your peace of mind...**

Market falls: don't lose your perspective

Market falls: don't lose your perspective

> **In the short run, the market is a voting machine but in the long run, it is a weighing machine.**
>
> Benjamin Graham

It is all too easy to panic when equity markets fall from their previous highs. As humans, we are hard-wired to be concerned about recent events and feel losses keenly. However, it is also easy to ignore the fact that interim losses occur with monotonous regularity. Reminding ourselves of this fact, along with being confident about the power of global capitalism, allows us to overcome some of the concern that we may feel from time to time. Top tip: don't look at the value of your portfolio too often.

It is not easy being an investor, but we can help ourselves

This volume of Acuity is written, not in response to the supposedly surprising and disappointing start to 2016 (or so the press would have you believe), but because of its very ordinariness. What we have witnessed is not extraordinary in the slightest, as we shall see. 'The worst start to the year for decades' is simply a good headline whipped up by the media.

What is also neither surprising, nor out of the ordinary, is the emotional response of investors who feel unease about short-term market falls. Worry, panic and, on occasion, the temptation to bail out of a sensible investment plan is not uncommon.

The sad fact is that, as human beings, we are very badly wired when it comes to investing. The mental wiring that evolved to allow us to make intuitive and rapid decisions to survive in the wilderness does us a huge disservice when it comes to navigating the short-term vagaries of the markets.

In the jargon of behavioural finance, the combination of focusing on short-term events, coupled with the well-documented fact that investors feel twice as much pain from losses compared to the pleasure of gains, is known as myopic loss-aversion. It is a dangerous mindset, if long-term successful growth of wealth is the goal.

The remarkable nature of wealth creation through capitalism

Let's start by looking at the remarkable, persistent and robust wealth creation of global capitalism. There's no doubt that, in extremis, capitalism can be divisive, cruel and abused - look no further than the evolution to 'managers' rather than 'owners' capitalism that pervades Wall Street and the City.

Yet it is a remarkable economic system that has delivered astounding results, in terms of innovation and reduction of global poverty, as well as increased human longevity and birth rates.

Capitalism is undoubtedly a driver of growth and prosperity in society, as the following points reveal:

- In 1899 Charles H. Duell, Commissioner of the US Patent Office, stated that 'Everything that can be invented has been invented'. Enough said.
- Even Bill Gates' vision failed to comprehend a future in 1981 anywhere near what has turned out to be the case today when he said '640K [of RAM] ought to be enough for anybody'. How wrong he was! The RAM on the computer that this article was written on is 8GB (more than 8,000,000K).
- It is estimated that around two-thirds of all those in school today will end up in jobs that don't yet exist!
- In our daily lives, things that a generation ago would have been seen in Star Trek, such as talking face-to-face with a friend or colleague on a hand held device are now part of everyday life, through FaceTime and Skype.

Innovation is not slowing but speeding up. Driverless cars are no longer science fiction, but a reality. Nuclear fission is no longer a pipe dream. The future is remarkably exciting.

Wealth creation is remarkably robust over time

The real (after inflation) growth in GDP provides us with a fair sense of how the world's wealth has grown. In fact, the world's GDP growth in 2016, for both developed and emerging economies, after taking account of inflation, is estimated be around 3%. This is despite all the doom and gloom peddled by market commentators.

It is easy to ignore just how remarkable this is because, as humans, we are hopeless at compounding numbers in our head. At this rate (using the Rule of 72), global output would double every 24 years. The figure below illustrates the real growth in GDP in the UK from 1948 to 2014. In 2007 the economy was booming, and in 2016 we now produce more than ever before, but it does not feel like the good times are back.

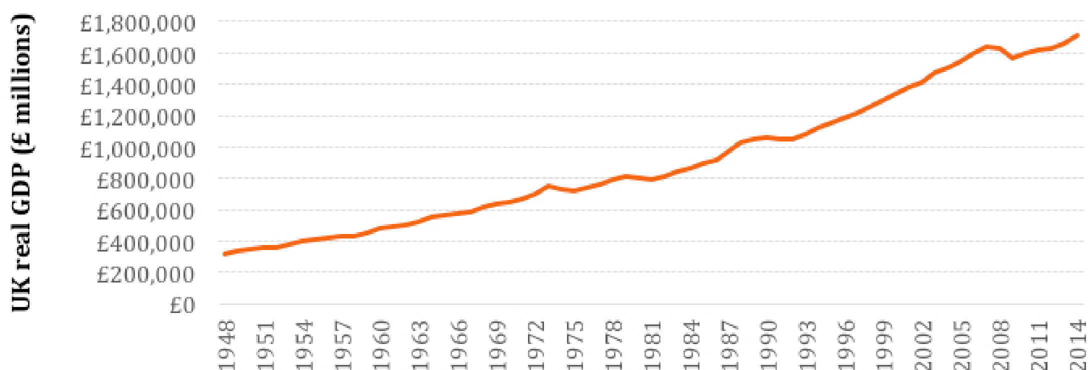

Figure 1: Real UK GDP in GBP – a remarkable story
Data: Office for National Statistics (ONS)

So, despite the robust and enduring growth of global wealth and an exciting and optimistic view of the future, why do we get so despondent when, along the way, the equity markets fall?

Benjamin Graham's voting and weighing machines

The subtle distinction between the long-term weighing machine (weighing up the economic returns due to investors providing capital) and the short-term voting machine that delivers the market's moment-by-moment prices, sits at the heart of the challenge that investors face.

At its simplest, a share's price is the present value of its estimated future cash flows, i.e. future dividends, and is determined by the collective knowledge of all investors in the market. Some will believe that the price is too high and will become sellers of the stock; and others will believe that the price does not do the company credit and be buyers. The equilibrium price at which buyers and sellers transact is the best estimate of the value of a company at that specific point in time, given the information available. As the release of new information is random, so will the movement of prices be, in the short-term.

Market movements simply reflect the aggregate impact of news on the future earnings prospects and risk of all companies that make up the market. The recent news that China's growth has slowed to a 'mere' 7% p.a. reduced the earnings outlook for companies around the globe and also dented some investors' confidence. This is Benjamin Graham's voting machine.

The weighing machine is the underlying, economic return – from dividends and the real growth in earnings - which an investor must eventually receive from the market, over time, driven by the interminable power of global capitalism.

The ordinariness of market falls

A simple way to illustrate how normal market falls are is set out in the figure below. What it shows is the depth and time that markets - in this case global developed market equities - spend falling and recovering back to the previous market high (the right hand scale). As investors we could spend most of our time being disappointed, if we allow ourselves to be.

However, take a look at the blue line (the left hand scale). It shows the growth of £100 over time, despite the frequent periods of being underwater below the previous market high. Note that these returns are after accounting for inflation.

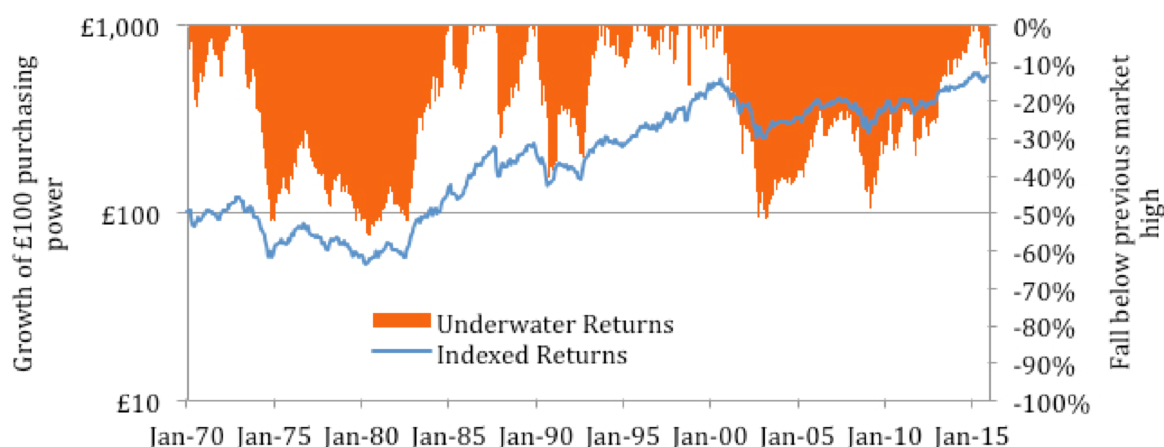

Figure 2: The depth and longevity of being below a previous market high (1970 – 2015)
Data: MSCI World Index (net divs.) in GBP, after inflation, from Morningstar © All rights reserved.

The compound (or geometric) return over the 45-year period was a little under 4% per annum, after inflation. That means that £100 invested in 1970 became £533 by 2015, despite the market crash in 1974, the oil crisis and sky-high inflation of the 1970s, the crashes of 1987 and 1990, the emerging market currency crisis of the late 1990s, the technology boom and bust, 9/11, the credit crisis from 2007 to 2009 and now China's slowing growth. That is a remarkable outcome – which long-term investors benefited from - scattered with frequent, deep and occasionally prolonged periods of market adjustment. This is evidence of the weighing machine at work.

Why investors struggle with short-term market movements

Unfortunately, we are hard wired to ignore our rational thought processes and focus on - and become emotional about – short-term adjustments to share prices. Three key behavioural flaws, deeply embedded over millions of years surviving as a species, work against us.

The first is immediacy; this is the propensity to focus on something that is happening or has just happened, such as the readjustment of the outlook for global companies given China's slowing growth rate.

The second is anchoring; humans have a propensity to fixate – or anchor - on a specific reference point; this might be the previous high level of the market, portfolio valuation or house price. Investors were pleased when the FTSE 100 passed through 6,000 in 2013, thrilled when it hit 7,000 in 2015 and despondent now we are back at 6,000 or so. It is easy to forget, too, that these companies paid dividends – one of the rewards of being an owner - of around 3% each year, not reflected in the index.

The third is loss aversion; this - as described above – is where the ratio of downside pain relative to upside pleasure is 2:1. Whilst that kept us alive in our pre-history, it hinders us as investors.

You can probably spot the problem and the conflation of these three traits when the market – acting as a voting machine - readjusts to new, less positive information. Unfortunately, the immediacy and pain is amplified by newspaper headlines, commentators such as Robert Peston (formerly of the BBC, whose favourite word during the credit crisis was 'contagion'), the evening news and irresponsible, headline grabbing research reports, such as that issued recently by RBS[1].

So what is the solution?

The rational approach to dealing with the problem of myopic loss aversion is to remember that the market movements do not reflect an absolute measure of despondency or elation in the economic world, but simply a readjustment of the price of shares relative to a previous view, based on new information.

However, given that most investors struggle to be rational when times appear bleak, we have a number of defences that we can erect around us, perhaps the most important being the ability to ignore or cut out the stimuli that agitate us.

The best place to start is by ignoring the headlines and laugh at the news, particularly when you hear that multiple billions have been wiped off the value of UK companies; that the market has reached a new high; or that we are entering a market correction or bear market, which are both arbitrary descriptors of ordinary market movements. Ask yourself: so what?

The other thing to do is not to look at your investments too often. The table below makes it obvious why. The more frequently you look, the more likely you are to see a loss, the more pain you will feel, and the more you will fixate on market 'noise', rather than focusing on the long term results of your investments.

As you can see, if you look weekly, you have an almost one-in-two chance that you will see a loss. In the worst week ever (during the period under review) the global equity markets fell by 22%. That is a frequency and magnitude of loss that most investors would find hard to stomach. Over any one-year period, you would have had a one-in-four chance of a negative return. Don't expect your portfolio to go up every year; it won't. Looking every five years reduces the chances of a loss to around one-in-ten.

'Look' frequency	Chance of loss	Chance of loss > -5%	Chance of loss > -10%	Chance of loss > -20%	Worst loss
Weekly	**45%**	**2%**	**0%**	**0%**	**-22%**
Monthly	**38%**	**9%**	**1%**	**0%**	**-22%**
Quarterly	**31%**	**13%**	**5%**	**1%**	**-29%**
6 months	**31%**	**16%**	**10%**	**2%**	**-33%**
1 year	**23%**	**16%**	**11%**	**5%**	**-32%**
3 years	**16%**	**12%**	**9%**	**6%**	**-45%**
5 years	**10%**	**9%**	**7%**	**3%**	**-28%**
10 years	**3%**	**2%**	**1%**	**0%**	**-13%**

Table 1: Looking too often is injurious to your health (Feb 1975 to Jan 2016)
Source: Albion Strategic Consulting. Data: MSCI World Index (net divs.) total return before inflation.
All losses are cumulative, not annualised.

If you can't help yourself from being concerned when markets fall, perhaps work your way through the following mental checklist. If the answer to most of these questions is 'no', stop worrying:

- Do you need access to the money invested today, or even in the next 5 years?
- Is the market falling a surprise to you?
- Has capitalism ceased to be a driver of global growth and wealth creation?
- Is the global economy shrinking?
- Is it a good thing to sell equities when they have fallen?
- Do you think that the market will be below where it is today in 10 years' time?
- Do ordinary patterns of returns warrant extraordinary actions?

Helping ourselves

In essence, our advice would be don't look too often at the value of your portfolio, stop listening to the hyperbole of the media and stop dwelling on the news. Do be optimistic about the power of the wealth creation potential of global capitalism, over the time frame you will be invested. We would even say, don't come to your annual review meeting worried about movements in your portfolio since your last review. What matters is whether the value of your assets is still within reasonable expectations, despite being down (or up). Short-term market movements are simply noise and best ignored.

Finally, remember when markets are down, one of the favourite sayings of the legendary investor, Jack Bogle: 'This too shall pass!'

End notes

1. http://www.telegraph.co.uk/business/2016/02/11/rbs-cries-sell-everything-as-deflationary-crisis-nears/

Other notes and risk warnings

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