Keep Calm and Invest On

By Donna St.Amant, MBA, Portfolio Manager
Point View Wealth Management, Inc.
http://www.ptview.com

Market ups and downs can easily derail the best of intentions. Emotions can run high as you see your life's savings decrease in value at a pace that always seems to move faster on the way down than it does on the way up. Understandable as it is, financial decisions based on these emotions can be costly.

During times of mild market volatility, investors do pretty well at sticking to their plan and continuing regular investments into the market. But when the market brings large losses day after day, that is when impulsive, and many times costly, decisions are made.

There are two common reactions to extreme market volatility. One is to pull out of the market altogether. Not only stop investing, but liquidate positions and move out of the equity market. Investors reduce a previously well thought out equity allocation to a much lower point. The second reaction is to do nothing at all. Stop adding to the portfolio outright or stop rebalancing, as it would require buying more stocks. The investor is paralyzed; often even refusing to sell positions that are at a loss.

Making it more difficult to do the right thing is that a decision to pull out of the market may be validated initially. Say the market falls another 10% after an investor pulled out. Initially he feels good about that decision, having saved himself additional loss. The problem is knowing exactly when to get back in. Many investors then stay on the side lines for far too long. By the time markets have truly stabilized they have already missed the rebound in returns. Some of the best market returns have come shortly after the worst declines. Over time this results in the investor selling at the lows and then buying high, after the market has run back up. This buy high and sell low behavior is a detriment to reaching long term financial goals.

It is not easy to invest without emotion, but there are some strategies to help.

Stick with your asset allocation and rebalancing plan. During times of turmoil it is more important than ever to be disciplined and continue to rebalance toward a set asset allocation. This is not the time to make a change to the allocation purely due to market volatility. A change in allocation is dictated by a change in lifestyle, not because of the market. An asset allocation plan only pays off when it is followed during different market cycles and over the long term. When stocks sell off, rebalancing will require you to buy more stocks. It is understandable that this feels wrong when stocks are so volatile. However, failure to add during these times leads to missed opportunity. If emotion takes hold, an investor may abandon an allocation strategy at precisely the wrong time and miss out on the opportunity to take part in the market rebound. Jumping in and out of the market will negate the long term benefit that an allocation strategy is intended to provide.

Use dollar cost averaging. Rebalancing should occur at regular intervals. This way an investor is adding to his holdings in small increments over time and it decreases the chance of buying or selling at the wrong time. This strategy creates more value than buying or selling all at once in an attempt to time the market.

Maintain a long term perspective. Volatility is unavoidable and the market will periodically experience a correction. Don't look at portfolio balances on a daily basis. Focus on what you can control.

Stay invested. It can be extremely costly to take money out during a downturn because the investor is selling at near lows and it is impossible to know the right time to get back in. He is likely to miss the rebound and sacrifice the market's best returns.

Stay diversified. Knowing that the portfolio is spread out across many sectors and asset classes will minimize the impact on your overall portfolio. Typically a downturn in stocks is led by one sector. Use this as a buying opportunity in healthy sectors that are dragging along with the broad market decline.

Market timing is risky. Some investors move in and out of the market in an attempt to time the market. This strategy will not produce consistent results and will sacrifice returns.

Be careful of chasing strong performers. The best performing stocks in one year are rarely the best performers in the following year. When investors experience fast increases in a stock or sector, it feels great and the tendency is to want to buy more. Again, emotion influences decisions and leads to buying at the highs.

At the same time, when a holding decreases in value, investors are tied emotionally to the price they paid for that stock. When it goes down it is common to hold the stock, waiting to exit at a price above what they paid regardless of the outlook for that company. The decision to continue to hold a losing stock should be dictated by research, not emotion. Perhaps it is smart to hold, or maybe those funds would do better if deployed elsewhere.

Emotion can be a reason an individual wants to trade his own portfolio. They consider it a hobby and see trading as fun. More active trading is more exciting, but in reality a disciplined and perhaps more boring strategy with less trading is more profitable for the average investor. A suggestion for those who wish to stay involved in the market is to carve out 10% of holdings for personal investments and active trading.

Most individual investors overestimate their abilities. Even those that are willing to commit the time to research and manage their own investments still fall prey to emotional decision making.

Economic and market uncertainty brings out fear resulting in impulsive decision making. The media can exacerbates these emotional feelings. The media has a near term goal of gaining attention and increasing ratings. They are not concerned with the longer term outlook. Bear in mind, by the time the media is reporting an event it is likely too late to do anything that would have a positive impact on your portfolio. When a large institution suggests to exit stocks entirely, this grabs headlines and causes investors to panic. This is most likely the worst time to sell out of your portfolio. Focus long term and stay the course.