ETF insight

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Managing market volatility

Strategies for making the most of uncertain times

If not placed in the context of either market history or investment horizon, a significant market drop will cause some investors to doubt the wisdom of their investment plans and become nervous. Then they jeopardize their long-term portfolios by making short-term decisions during the turbulence. They forget that a portfolio stocked with quality investments, and coupled with the right mix and timeline, will ride out the storm.

Investor nervousness during market upheaval is not entirely unpredictable, given the effect of so many media delivering the information. The facts may be identical but the cumulative effect of numerous outlets providing the same data with different emphases means that some hysteria is inevitable.

Investors who conclude the worst, react accordingly. They sell at the worst possible time and their panic selling in the midst of the turmoil further drives down share prices. They hope to 'cut their losses' but only succeed in turning paper losses into real ones.

Some try to time the market by selling with the hope of buying again when things are about to improve. This is a futile activity. The noted professor of finance and winner of the Nobel Prize in Economics, William Sharpe, proved statistically that a timer has to be right 74% of the time to benefit from market timing.

Volatility can be unsettling but it can also be a friend. For long-term investors, it opens the door to opportunity. By concentrating on valuations, they benefit from the downward impact of emotional selling and add to quality positions at better prices.

Dollar-cost averaging techniques work well in volatile markets. Instead of purchasing in a lump sum, investors ease into an acquisition by buying over a long period, eliminating any inclination to time the markets and reducing the cost base.

Simply speaking, when the market is up you pay more for fewer shares but as the market drops you receive more shares for the same amount. The lower average price per share means that when the markets rally, as they always do, the returns are bigger.

Business Insider did an interesting dollar-cost averaging calculation with a hypothetical investor entering the markets at a high point (Oct 2007) and contributing the same amount monthly into an S&P index fund until December 2013. Despite enduring the crisis of 2008, the return was 48% or roughly a 7.6% annual rate of return.

With markets likely to remain erratic over the near-term, investors could also consider incorporating defensiveness with dividend-paying stocks. Consistent cash returns ease dependency on market price appreciation and help reduce

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portfolio volatility. Sustaining and increasing regular dividends are also important indicators of a company's quality.

It's a given that stock markets fluctuate but it is also true that well managed and solidly performing companies recover. Therefore investors with carefully crafted investment plans that include high quality businesses should trust their plans to get them through any periodic turbulence. It takes discipline to remain calm in rough seas, but investors can learn from experienced sailors: "To avoid seasickness, keep your eyes on the horizon."

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