

PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

Prepare for Heightened Volatility

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Since September, market volatility has escalated because of concerns regarding inflation, supply chain constraints, accelerated tapering by the Fed and likely higher interest rates in 2022. These concerns, along with the Omicron variant and trouble hitting China's vast and highly indebted real estate sector, are likely to sustain high market volatility as we enter 2022.

Most investment mistakes are behavioral in nature, often originating from emotional reaction to market volatility. How you react to each recurring bout of volatility will determine to a large extent the long-term success you will have with your investments. Extensive research in the fields of finance and psychology has shown that we are naturally wired to want to "flee" or avoid such volatility. Many will repeatedly act on this natural impulse by selling securities, typically after they have already dropped a lot. In fact, studies have shown that those who try to dart in and out of their investments (stocks specifically) to mitigate volatility suffer around **a 7% per year opportunity cost**. That could be the difference between a comfortable and secure retirement and outliving your money. To navigate any such volatility successfully, you need to equip yourself with a set of tools that form a part of an effective coping system.

Thanks for your referrals!

As we conclude our twenty-seventh year of publishing *Observations*, we would like to take this opportunity to express our gratitude and appreciation to all our clients and friends for their client referrals over the past year. We always welcome the opportunity to be of service to relatives, friends, and acquaintances of our clients. As many of you know, we do not market our services to people with whom we are not acquainted. Our business has grown over the past twenty-seven years primarily due to satisfied clients adding business and through their referrals. We hope you'll think of us if you come across anyone who would benefit from our services. Thanks again!

The first tool that you need is **historical perspective**. On the next page is a table based on data from J.P. Morgan Asset Management which quantifies the largest intra-year market declines from peak to trough for each calendar year between 1980-2020. From the table you can see that we have endured nasty market drops (aka *negative* volatility) in most years covered by the table. While not apparent from the table, history shows that you also had to endure lots of interim ups and downs as those declines developed.

Inside This Issue:

- Prepare for Heightened Volatility p.1

Largest Intra-Year Declines (1980-2020)

Year	'80	'81	'82	'83	'84	'85	'86	'87	'88	'89
Intra-year decline	-17%	-18%	-17%	-7%	-13%	-8%	-9%	-34%	-8%	-8%

Year	'90	'91	'92	'93	'94	'95	'96	'97	'98	'99
Intra-year decline	-20%	-6%	-6%	-5%	-9%	-3%	-8%	-11%	-19%	-12%

Year	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09
Intra-year decline	-17%	-30%	-34%	-14%	-8%	-7%	-8%	-10%	-49%	-28%

Year	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19
Intra-year decline	-16%	-19%	-10%	-6%	-7%	-12%	-11%	-3%	-20%	-7%

Year	'20
Intra-year decline	-34%

Source: Standard and Poor's, FactSet, J.P. Morgan Asset Management Guide to the Markets 4Q 2021.
Market returns are based on S&P 500 Index price only and do not include dividends.

The table shows that during the 41-year period from 1980 to end of 2020, the worst intra-year drop was *negative* 49% in 2008, a year that was full of + and -3% market days. The intra-year drops during that period ranged from *negative* 3% to *negative* 49%, with an average of *negative* 14.3%. Let's put this in perspective – the dreaded “bear market” is conventionally defined as a 20% decline. So the *average* intra-year decline of the past 41 calendar years was only 5+% short of a bear market. And more importantly, the market still managed positive annual returns in 31 of the past 41 calendar years despite these recurring and distressing intra-year declines. ***Put simply, there is a very high probability that the market will experience a nasty drop in any one year (punctuated by smaller interim ups and downs). Still, the odds are good that the market will end the calendar year producing positive returns. The main point is that it may feel terrifying while going through a severe market decline, but markets unfailingly rebound over time.***

A second tool you need is *patience to give your investments time to work out*. Market or security volatility diminishes substantially with the passage of time. Market returns over any single calendar year can and do deviate substantially from the long-term average market return. Obviously, security prices during any period shorter than a year (e.g. a single day) will fluctuate even more, often for no good reason at all. Average annualized market returns over rolling 10-year periods are much more tightly bunched around the long-term market return average. ***This is a remarkably simple and powerful tool to deal with volatility – be patient and invest with a long-time horizon.***

Investing with a long-time horizon also allows your investments time to rebound. J.P. Morgan Asset Management put out a “Guide to the Markets” in mid-2011 that discussed how quickly some past market drops rebounded. The guide used the S&P 500 Index, on a price basis only, as the market proxy. Combining the data from the guide and the S&P 500 Index price data in subsequent years, the results show an average drop of about *negative* 33.7% over the past twelve bear markets. ***Interestingly, the number of years that the index took to rebound from a bear market low to the previous market peak ranged from 0.2 year to 5.8 years, with an average of 2 years. So, typically it does not take that long for markets to rebound fully from bear markets.***

A third useful tool is the ability to recognize and resist some common behavioral pitfalls (discussed below) to which we are all vulnerable, especially during periods of high volatility. This will help you maintain the appropriate reaction as well as make you a better investor.

Anchoring

Anchoring uses reference points that are misleading or irrelevant to make decisions. An example would be mistakenly thinking a stock must be undervalued if it has dropped a lot, let's say from \$20 a share to \$14 a share. Using \$20 a share as reference to determine the stock's current valuation may be misleading if that former price was ridiculously high. Another example of anchoring is investors fixating on their purchase price for an investment, which has nothing to do with how much the stock might be worth going forward. Sometimes it is better to sell and move on rather than to wait for "break-even," if the company behind the stock is in permanent decline.

Many investors may avoid stocks for good after anchoring to painful or lackluster market periods. However, the history of the markets shows unequivocally that financial markets go in cycles. The more extreme a trend gets, the closer it is to an inflection point where the trend starts reversing. In contrast, investors tend to extrapolate current trends, when all evidence shows that markets regress towards a long-term mean.

Confirmation Bias

Confirmation bias refers to making a decision and then looking for **only** data or information that support rather than refute your thesis. An example would be you ignoring all negative news affecting a stock that you own. Because it is natural for us to seek out conforming opinions, it is especially important to fight this natural tendency by examining evidence that contradicts your views, such as contra-cases presented by short-sellers of your stock.

Another example would be you thinking it is a good time to sell a stock, and seeking only information that supports your decision. During periods of market volatility, it is too easy to be bearish and look for only negative news or stories to back this up.

Recency Bias

Recency bias is the tendency to focus more heavily on recent events while ignoring the lessons of the past. Rather than making decisions with a longer-term perspective, this bias leads you to put more weight on recent events. This is one of the main reasons investors tend to buy high and sell low. When tech stocks with little or no earnings were hot in the late 1990s, investors piled into them with a view that they would enjoy unlimited growth that justified their absurd valuations even though a historical perspective would have better informed investors of the bubble developing.

Likewise, during the 2008-2009 meltdown, many investors thought the financial markets would never rebound and pulled billions of dollars from stock mutual funds, in the face of a long history demonstrating the market's resiliency over time. These investors missed out on the subsequent robust rebound in the stock market, doing significant damage to their long-term financial security. Broadening your perspective and taking into account market history will help you understand and accept that volatility is always present in the stock market, which has gone up over time despite recurring volatility, recessions, natural disasters, wars, geopolitical crises, and other negative events.

Loss Aversion

Ample research in the field of psychology shows that most of us are loss averse, meaning that the pain we suffer from losing is about twice as intense as the joy from winning. This has all sorts of important implications for investing. One common behavior stemming from loss aversion is that investors are much more willing to realize gains

by selling winning stocks (because they don't want to lose those profits and suffer regret). On the other hand, they are very reluctant to sell and realize losses, waiting instead for break-even. This ties up capital that can be more profitably deployed elsewhere.

Another example of loss aversion is investors incessantly worrying about a small-loss position, which has a negligible effect on the portfolio. Such investors spend an inordinate amount of time obsessing about this one position at the expense of tending to other more important positions in the portfolio.

Loss aversion can often lead to panic when markets are dropping, even though you may not need the money and should welcome lower prices to buy in. The fear of further losses is so great that investors panic out of the market. It may cause people to put too much into bonds and cash and not enough into stocks. Consequently, over a typical retirement period of 30+ years, invested savings fail to keep up with inflation. Also, loss aversion often leads to the most intense selling of stocks near market bottoms.

Herding

Herding is a form of behavior that follows and finds comfort in consensus. Consensus is good for many human and social endeavors, but lethal when it comes to investing. If there is a consensus about a stock, people have already acted, and the price already reflects that fact. Psychologically, we seek out comfort and safety in numbers, especially when we face situations of great uncertainty and serious consequences. Investing involves precisely such uncertainty and consequences.

Fear and greed are human traits that will always be with us; the herding effect tends to worsen these trends once established. In a sense, believing the market is always roughly right in pricing securities is the biggest herding trade ever, because you are substituting a lot of people's judgment for your own. Performance chasing is another harmful herding activity. Professional investment managers are some of the worst herding offenders; they herd to avoid criticism. They think it is ok to mess up, as long as they act like their peers and competitors.

Media is notorious for promoting herding, often by mindlessly reinforcing consensus viewpoints. Shows like CNBC are mostly entertainment; it is fun as long as you see it for what it is. But a lot of financial writers and journalists, whether in print, online or broadcast, don't know their subject very well. Since misinformation is being disseminated on a daily basis, it is important to separate what is helpful from what is damaging in order to keep ourselves from falling into the traps of euphoric buying at high prices and panic selling at depressed prices.

It is difficult to fight human nature. When the markets are swamped with negative news and experiencing sharp declines, it is natural for you to feel a need to change your investment plan. But historic data show that market volatility is normal and intra-year declines can be expected every year; the stock market has rebounded every time, through wars, corporate bankruptcies and a host of other challenging events. Falling victim to behavioral mistakes could significantly hurt your financial situation in the long run. This is why it is crucial for you to maintain a proper perspective beyond "the here and now" and remain disciplined with your long-term investment strategy notwithstanding inevitable bumps along the way. Keep all this in mind as market volatility is likely to continue in coming months.