Fidelity WORLDWIDE INVESTMENT

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Education

Market slumps happen

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There is a rich seam of wisdom about how to respond to market slumps. This points to two things. First, it says that market volatility is not unusual, it is a shared experience and therefore worth commenting on. Second, it suggests that most people do the wrong thing when the market falls – if people knew how to react there would be no point in the greats trying to put them right.

Peter Lynch, the former Fidelity investment legend, put it well: “Everyone has the brainpower to make money in stocks. Not everyone has the stomach. If you are susceptible to selling everything in a panic, you ought to avoid stocks and mutual funds altogether.”

Warren Buffett was just as forthright: “Unless you can watch your stock holding decline by 50% without becoming panic-stricken, you should not be in the stock market.”

Two principal problems are highlighted by these comments. First, investors are human and so revert in periods of stress to atavistic emotional and cognitive short-cuts rather than employing rational thought. Second, they are prone to two unavoidable behavioural biases – they follow the crowd and they do whatever they can to avoid the pain of loss.

What both of these great investors understood and the rest of us need to keep reminding ourselves is that the volatility of the market is simply the price we pay for the long-term outperformance of shares. We need to find the stomach if we are to capture the remarkable returns of the stock market over time. For those of us for whom the Buffett and Lynch state of Zen calm does not come naturally, here are 10 things to tell yourself when you need to get a grip.

1. Volatility is normal. If we are prepared for turbulence we won’t be surprised when it happens and we will be more likely to react rationally.

2. Sticking with your investments pays off because equity investors are compensated for market volatility. US shares have outperformed bonds and cash over the past 10, 20, 50 and 89 years since reliable data emerged in 1926.

3. Corrections create opportunities. Nothing has changed over the past two weeks except the price at which Mr Market is prepared to sell you his shares.

4. Timing markets consistently is impossible and trying to do so is extremely risky. That’s because missing just a few of the best-performing days can seriously compromise your long-term returns. If you had remained fully invested in the S&P 500 between 1992 and 2015 you would have made 697%; missing the five best days would have reduced that to 429%; if you had missed the best 30 days your return would have been just 64%.

5. Regular saving takes the emotion out of investing. Drip money into the market automatically every month and you will always buy at the bottom (when your mind is telling you to do the opposite).

6. You don’t have a crystal ball so be well-diversified. A balanced portfolio will smooth returns and limit short-term falls.

7. Focus on quality. Companies with strong balance-sheets, the ability to generate cash, powerful brands, market share and

pricing power won't be immune to market turmoil but they will bounce back more quickly. The compounding of their better returns over time will transform your returns.

8. Reinvest your dividends. The FTSE 250 index has risen nine-fold in the past 25 years. With income –reinvested it has risen 18-fold. The magic of compounding again.

9. Don't let short-term sentiment distract you from the long-term story. Online retail sales in China rose 49% last year. The country spends more on research and development than anywhere except the US. The transition from unsustainable export and investment-led growth to sustainable consumption-led growth is bumpy – but it is happening.

10. Finally, stock markets are markets of individual stocks. In volatile markets the good are often marked down with the bad. Stock-pickers can take advantage of this. You want to invest in tomorrow's winners and avoid tomorrow's losers – if you can do that at an attractive price because the market has lost its head, so much the better.

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