7 things successful investors do in volatile times

If you and your clients are feeling a little bombarded by news about US and Australian elections, 'Brexit' fallout, global growth, government debt, record low interest rates (negative in some parts of the globe), high valuations, declining earnings, Chinese data releases, commodity price weakness, see-sawing currencies – and wondering what to make of it all, I have some news for you. Take comfort... you are not alone!

In fact, investors everywhere are grappling with the same big question:

"How do I generate my required return in a low return, high volatility world?"

Yet while a lot of investors are dealing with the same issue, there are some big differences in the responses. Some fall victim to the 'cycle of investor emotions', becoming hostage to their 'lizard brain' where fight and flight responses either quickly destroy, or gradually erode, their total wealth. Others take a far more structured and disciplined approach, falling back on an established wealth strategy and decision making process as the basis of their hope they will "get through this time too".

When all is said and done, history and experience show your ability to deal with a volatile environment will stand or fall on your STRATEGY, your DISCIPLINE, and your PATIENCE.

Lessons from a Grandmaster

When it comes to strategy, discipline and patience there are a lot of parallels between investing and the world of chess, the ultimate game of strategy. The words of Danish Grandmaster Jorgen Bent Larsen are instructive for investors. When asked about the biggest stumbling block to succeeding in the game of chess, he responded:

"Lack of patience is probably the most common reason for losing a game, or drawing games that should have been won".

By the time anyone reaches the level of chess 'Grandmaster', it is safe to assume they are quite brilliant at strategy, and extremely disciplined in developing their understanding of which moves work best in different situations. But even they have to fight against their human behavioural impulses. Those who succeed most have learned the ability to exercise patience in executing their strategy. And so it is with investing.

The Great Wealth Transfer

High volatility environments may not look like much from a return perspective 'on average', but as we know, averages can hide some extreme movements. This is where temptation comes in. When you are sitting back looking at record low interest rates and yields, you realise you need to jump in and start earning more return at some point. But on the other hand, when you are seeing market moves in the order of 10-15%, it becomes all too easy to succumb to the 'deer in the headlights' feeling and stay put.

A typical output of this combination of emotions is to buy high (thinking you are missing the move), and to sell low (thinking markets are about to implode and its now about capital survival).

Of course in a perfect world, we would all be buying low and selling high … right? Unfortunately, the imperfect world of financial markets, with all the uncertainty that comes with it, means we have to settle for a less than perfect scorecard in achieving this lofty aim. BUT, if we can manage to buy low/sell high more often than we buy high/sell low, we are on track to achieving our long term investment objectives.

This is where patience comes in. In the current environment investors can become easily trapped into chasing the market when nearing the top end of a large volatile range. Despite the strong bounce off the February lows in global equity, credit and commodity markets, we have to account for some 'undeniable truths'. Global growth is sub-par but recession risk remains low, inflation is still not a significant issue, developed equity markets remain expensive, earnings continue to deteriorate, defensive asset valuations are not much better - bond yields are at record lows thanks to QE policies (and around one-quarter of government bonds on issue globally have negative yields) AND geopolitical risk is all around us. At some point, these truths will collide with the aspirations of even the most bullish investor. And most likely sooner than later.

In a world where we expect the 'low return/high volatility' theme to continue for some time, we will likely see another 'Great Wealth Transfer' from the impatient to the patient investor. The impatient will chase the highs and exit at the lows, while the patient will withstand the temptation to 'chase', understanding the times we are in and working the longer term strategic plan just like a grandmaster. Applying their strategy with discipline and a great deal of patience.

Your '7-point plan' for staying patient

Obviously, you want to be on the receiving end of any wealth transfer, so here's a 7-point plan to help you stay patient and successfully come through a low return, high volatility environment.

1. Understand the 'lay of the board'

You need to understand how all the pieces line up. In this sense, you need to have some understanding of the big picture and the key drivers of market movements. This will help you in your search to distinguish noise from substance, and when markets have gone too far – presenting risks to be managed, or longer term opportunities to be captured.

2. Get Real … you MUST make the mental adjustment

Annual investment returns for an Australian investor in a typical 70% Growth/30% Defensive portfolio have generally been very strong since the end of the GFC. In fact, in 2012 and 2013 real returns to a typical 70/30 fund reached levels in the mid to high teens. With this as a backdrop, it's hardly surprising that when returns have been strong for many years, valuations get expensive and the upside return potential gets smaller.

We seem to forget markets don't always go up. What we are experiencing now is called gravity, so get used to it. If you make the mental adjustment to a lower return outlook you will understand some adjustment is necessary for a period, but you won't get spooked out of your strategic investment plan.

3. Diversify … but do it intelligently

The benefits of diversification are a well-established pillar of modern investing. BUT what is less discussed is the nature of diversification necessary to reap these benefits. In this market environment, it is important to realise diversifying by 'name' is different to diversifying by 'risk characteristics'.

When it comes to traditional asset class categories (even at the broader growth/defensive level), just because something is called an equity exposure, and something else is called a bond exposure, doesn't mean they will necessarily provide you with a diversification benefit when you need it most. Or even if something is called a bond, it doesn't mean it doesn't act more like an equity in terms of its risk characteristics. When things get volatile and policy distortions abound, it is critical you understand the actual contribution to your portfolio risk that any investment brings in. Real diversification is the key.

Seek alternative sources of return with lower correlations to traditional assets like shares and bonds AND be careful which risk bucket you put traditional assets into. For example, are you putting hybrids or high yield bonds into your growth or defensive bucket? Your answer can have a significant bearing on the actual risks in your portfolio, rather than the ones you think are there!

4. Stick to the plan … your discipline and patience WILL be tested

The manner in which your strategic investment or wealth plan is constructed is critically important. It needs to be aligned to achieving your long term objectives, consistent with your preferences and risk tolerance, grounded in reality and robust through varying market cycles. If it's not, you need to make it a priority to revisit it and ensure it meets these criteria.

Once this is in place, the patient investor understands it is a robust process that has navigated challenges before and will do so again. Remember, your approach to market gyrations will be driven in part by the timeframe used. Strategic plans are there to keep you on track to your long term objective. Take care not to undermine it with short term reactive decision making. Get the foundation right first, then stick to it.

5. Keep some powder dry … volatility equals opportunity

Volatility is both a blessing and a curse for investors. While very few enjoy a stomach-churning wild ride in their returns, it is a fact of life that volatility also provides opportunities to build-in significant longer term returns. Even if returns are 'on average' lower in a large volatile range, the patient investor understands the importance of keeping some powder dry (cash on hand) to take advantage of opportunities when markets overshoot to the downside. This is why active investment managers typically do better when volatility picks up.

The variance of valuations attached to given shares or investments increases as investors respond to new information differently. Creating greater scope for misevaluation, and greater opportunities to access solid investments at more attractive levels. In a lower return, higher volatility environment every basis point counts, so it's important to capture opportunities to build in a valuation buffer to provide a cushion when markets test the downside.

6. Stay close to strategic allocations … big bets are less rewarded

Volatile environments are full of noise. This is especially the case in a data-driven market like we have at present where good news is good news one moment, and treated as bad news the next. Making large strategic allocations in this type of market can become a trap. The potential for 'whip-sawing' (i.e. violent reversals causing buy-high/sell-low results) increases dramatically.

The 'noisier' the market environment, the more you need to step back and understand how a market movement looks with respect to different timeframes. A move may look big in a tactical timeframe, but insignificant in a strategic timeframe. Take care to not make big allocation shifts on the basis of strategically insignificant movements, and especially those not consistent with fundamentals.

Understand the significance of an opportunity with respect to timeframes. In this type of market, with full valuations and high uncertainty, it is prudent to stay close to your strategic asset allocation, allowing some leeway either side to capture tactical opportunities across asset classes if they over/undershoot. The smaller the timeframe, the larger the risk in making big position adjustments. Keep any big asset allocation shifts for moves that are significant in strategic timeframes, and consistent with underlying fundamentals.

7. Security selection within asset classes is key

Staying close to strategic allocations doesn't mean doing nothing at all. As we've already noted, volatility creates opportunity. In a market where the combination of macroeconomic and market fundamentals may not provide strong signals one way or the other at the asset class level, it is important to understand there are still plenty of opportunities for generating additional return INSIDE various asset classes.

This highlights the importance of security selection in a low return/ high volatility environment. That is, the patient investor understands they need multiple arrows to their bow when it comes to return generation and risk management. Strategic asset allocation keeps you on track to your ultimate objective. Tactical asset allocation (within predefined risk limits) addresses shorter term risks and opportunities, providing an entry point to a larger position in the event it becomes more strategically important.

Active security selection adds another layer to the strategic asset allocation return, and is especially important when markets are driven more by macro factors than security-specific fundamentals… like the present.

The Strategy: Stay Patient

Adhering to these 7 points will go a long way to keeping you on the right side of the ledger when it comes to the great wealth transfer. Don't give in to emotional responses to market movements. Strong though the temptation may be. Earlier we discussed how your ability to deal with a volatile environment will stand or fall on your STRATEGY, your DISCIPLINE, and your PATIENCE. Learn well the lessons from a chess grandmaster, and make sure you are the patient investor building a strong foundation for long term investment success.