Second Quarter 2022

Coping with Market Downturns

Just when it looked like the Covid pandemic was falling behind us and life was getting back to normal, Russia invaded Ukraine and every hope for a calm investment year went out the window.

With unknown repercussions of the Ukrainian invasion and the long-term impacts of an unprecedented array of financial sanctions against Russia looming over the market, joining the threats of continuing inflation and supply shortages, and the potential for further Covid disruptions, it isn't surprising many investors and media commentators are beginning to sound more than a bit panicked. What's next? Recession? Bear market? A European war? And what does it mean for your investment portfolio?

The truth of the matter is we don't know what will happen next week or next month. What we do know is that markets go through periods of high volatility and uncertainty. Even in times without geopolitical tensions, financial markets are cyclical, moving from undervalued to overvalued, cycling briefly through a reversion to the mean or average price earnings (PE) ratio before swinging to the next extreme. While it would be nice to think that we can set rules and expectations that stock prices will comply with, in the short-term, market trends are by-and-large driven by emotions.

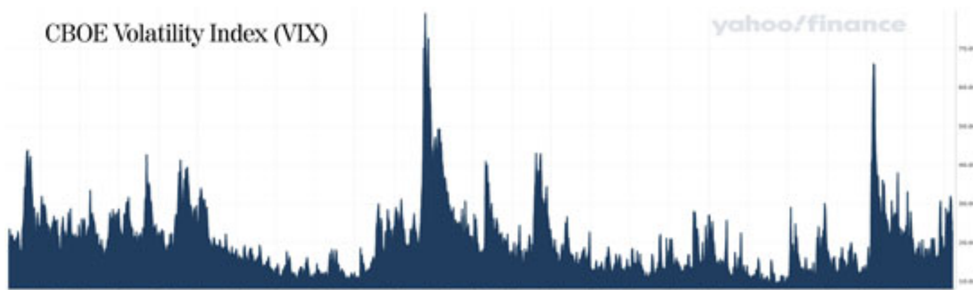
Media commentators like to provide a simple summary for why markets went up or down and what influenced investors on a particular day. The likelihood that their analysis is correct is next to zero.

Markets are the sum of billions of investors worldwide reacting to their own perceptions, compounded by computer programs striving to make a profit from often miniscule moves. That's not to say one can't be successful as an investor, but success requires NOT reacting to the latest media panic.

To be successful over the long-term, investing requires:

1. An understanding that there will be up markets and down markets, that stock prices are volatile and often fail to follow logical rules.
2. An investment strategy that guides how we react to the prevailing trend or market uncertainty.
3. Discipline to stick with the investment strategy.

There's only one way to begin to understand market volatility and cyclical trends. You need to study past markets. While history never repeats, it does tend to rhyme. Look at market charts, find out what was happening during periods of extreme movements. In every market there have been winners and losers. What characteristics did each display? If this isn't your forte, find an advisor who studies the markets and can explain how that knowledge has impacted his or her approach to investing.



Source: finance.yahoo.com;

Extreme price fluctuations are the norm, not the exception when viewing markets long term. The graph above shows the Chicago Board Options Exchange's (CBOE) Volatility Index (VIX), a popular measure of the stock market's expectation of volatility based on options activity in the S&P 500 index (SPX).

There are many ways to invest successfully. But one of the surest ways to lose money in the financial markets is to continually change course, chasing the latest hot investment fad. This is why an investment strategy is so important. As an investor, it is impossible to comprehend the complexity and opportunities of the entire global market. You have to identify where you have the ability, knowledge and fortitude to potentially be successful. This is the start of an investment strategy.

An investment strategy can be as simple as buy an S&P 500 index fund and hold for the long term. But this works best if you have a lot of money that you are unlikely to need if the market takes a dive, and you can wait 5-10 years to recover. Even then, there's no guarantee that your investment will be successful over your investing time frame. If you have limited time and you need your funds to be earning returns rather than recovering from a 20-40% loss, you need a different investment approach than you might take with a 30-year investing horizon.

In our investment advisory firm, we take the approach that every market environment has opportunities for profit if you are flexible and utilize an investment approach that helps you identify when the risk of holding individual positions is too high and how to find opportunities in a given market situation.

A sound investment approach doesn't have much value if you find yourself second guessing your strategy and making random moves without a plan. If you don't have the confidence and discipline to stick with your investment approach, you are back to chasing the latest investment fad.

Every investment approach will have losing trades. There can never be a guarantee of success. This is a business without certainty. Coping with uncertainty requires flexibility, not panic.

Replacing panic with an investment strategy requires accepting that investing always has risk. The amount of risk you can afford to take depends a great deal on how much wealth you have, when you will need your funds and your mental ability to cope with loss. Without an investment strategy, too many individual investors buy high out of fear of missing out and then sell low because they cannot bring themselves to change directions until the pain is too great. A late sell is too often followed by the reluctance to reinvest as the market recovers until they have missed much of the opportunity to recover their loss.

It is this cycle of panic followed by a reverse panic that devastates portfolio returns. It is also the reason many investors choose to retain an investment advisor that has a strategy and approach to the markets that makes sense and tries to avoid making emotional decisions. We know the market goes up and we know the market goes down. In order to navigate the markets, we must have faith, patience, and the emotional fortitude to stay the course.

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