HOW TO KEEP YOUR WITS WHEN VOLATILITY OCCURS

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Pick any day or a couple of days when markets swoon and one thing is as sure as Newton's Law of Gravity: the Pavlovian reaction of greed and fear among investors. When you throw in 24/7 news cycles of social media speculation and news with reports lacking historical context, it's easy to see why a herd mentality of an encroaching panic can set in.

After nine years of an historical bull market, when there's a headline-driving market drop like we've enjoyed this fall, it's important to have a battalion of sober minds to counter the anxiety that the next Black Monday is just around the corner. A couple of tweets from October come to mind.

Ben Carlson at Ritholtz Wealth Management offered this fundamental perspective on markets: "Why do stocks fall by a lot sometimes? Because sometimes they rose too much. Why do stocks rise a lot sometimes? Because sometimes they fell too much. Repeat as necessary."

Markets will always seek equilibrium even if investors have a hard time with it.

Michael Batnick, the author of "Big Mistakes: The Best Investors and their Worst Investments," provided historical context: "Yesterday was the third worst point decline for the Dow since 1915. But it was only the 284th worst day. A Black Monday (1987) type of event would have whacked nearly 6,000 points off the index."

Or as Barron's wryly noted in a headline: "The Dow drops 412 points because everybody is afraid of something."

To be fair, as we have learned from our own clients, part of this can be reduced to 'what has the market done for me lately'. It's a good point because after a buoyant 2017, 2018 has been a party pooper. By any measure, 2017 was phenomenal as all asset classes were at positive performance level: international markets were up 25 percent to 30 percent, domestic equities rose as did domestic and international bonds.

It was enjoyable to be an investor in 2017 with nothing but good at play. This often breeds complacency and "recency bias" as we come to believe the past can be extrapolated into the future.

By comparison, in 2018, every major type of investment has fared poorly, delivering flat or modestly negative returns. Emerging market assets that soared 37 percent in 2017 are down 12 percent to 16 percent in 2018 but by their nature, this type of volatility is to be expected. (See The Cyclicality of Markets).

What happened? Perhaps a return to normalcy. As Batnick recently noted when looking at the Nasdaq 100, 2017 was an outlier as only 10 percent of days had 1 percent moves (up or down). The median average from 1986 to 2017 was 38 percent and the average in 2018 so far has been – yes, you guessed it – higher than 38 percent.

It was a decade ago when the economy crashed like a house of cards and everybody was afraid of something and for a good reason. Nobody knew which big bank would be the next to fall or if the domestic auto industry would survive or if the job loss figures would stop at one million a month.

The economic recovery that began in June 2009 will be the longest in American history if it lasts into mid-2019. We have virtually full employment, markets have been overall stable and business confidence is high. But history tells us that downturns happen when economies are strong, and the fault lines of a downturn are opaque.

We believe as bad as fear can be, complacency can be equally corrosive because it sets expectations that are unreal. People are blasé psychologically and unprepared for the jolts that can come with a complex economy in which we live.

At times like these, it's worth listening to the blunt reminder of Howard Marks of Oaktree Capital: despite all the noise to the contrary, investing is not easy. "Everyone wants to make money. It's a very competitive activity," Marks recently told Barron's. "But one of the keys is to keep your emotions under control. Everything in the environment conspires to make us do the wrong thing, to buy when things are going well, and prices are high – and to sell when things are going poorly, and prices are lower, which is the exact opposite of what we should do. But it all comes from emotion. We have to resist."

Which is why psychology and coaching are critical parts of our job: to offer the best of analytical tools and understand the risk tolerances of our clients; to help them mentally and financially prepare for the unknowable by offering reasoned, factual counsel and historical context. In short, to help them resist the temptation of unintentional failure.

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