



Volatility is normal part of stock market

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Our human nature makes it difficult for us to adjust to and accept the stock market's erratic rollercoaster ride.

We have had plenty of experience with volatility lately.

Early August was a prime example. In the three trading days following Aug. 3, the S&P TSX was down 8.9 per cent. Then, over the next three trading days that followed, the index was up 7.4 per cent. We all know the markets go up and they go down. But what we might not understand is that the recovery of a loss is an uphill battle.

If an investment goes down 50 per cent then how much does it have to recover to return to the original value? Is the answer 50 per cent?

No; if a \$100 investment plummets to \$50 that is a 50 per cent decline. However, for it to climb back up to \$100 it has to double, or increase by 100 per cent.

The discrepancy is not as pronounced for a smaller magnitude of volatility. For example, a \$20 decline for the same \$100 investment would be a decline of 20 per cent. A full recovery of that \$20 would require an increase of 25 per cent (20 divided by 80).

Those are just numbers, but the more interesting aspect is how that affects our emotions since extreme volatility makes us very uncomfortable.

Behavioral studies have shown that the pain an investor feels at a decline of say 10 per cent is far greater than the joy from a positive return of that same amount. Investors may like to win but they really hate to lose.

Do you agree with the research? Do you feel more emotional about a loss than an equal-sized gain?

The reality of how people deal with losses impacts many investment decisions. Consider the following situation as it has likely happened to you.

After an investment has declined 20 or 30 per cent, what did you do? Did you sell it? Did you hold onto it? Did you buy more to lower your average cost?

Investors often find it difficult to sell an investment that has declined in value. After the decline the hope is that it will return to its previous value and then some. Sometimes this happens, sometimes it doesn't.

There are countless cases of stocks which have taken a beating, and never recovered.

Nortel anyone? Some may think it's not really a loss until you sell and 'realize' that loss. No, a loss is a loss. Any product is only worth what you can sell it for.

Usually there is a pretty good reason why a stock has been crushed. Have the fundamentals of the company changed? Maybe it is just part of a general market decline.

Regardless of the reason behind it, an investor needs to have a strategy for handling large declines. Volatility is a fact of life with stock markets. You should expect it and know in advance what you are going to do when it happens. An investment policy statement can serve you very well in times like these.

Unfortunately, emotion gets in the way and too many people sell out of fear rather than discipline. Curiously, when investors throw in the towel it is often close to a market rebound. We have terrible timing. We should not even bother trying to pick good buying times. Discipline is the key.

If you have your written strategy, volatility should be nothing more than a normal part of the market experience.

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