Market Volatility and the Urge to Do Something

In one of the biggest upsets at the recent World Cup, Morocco eliminated powerhouse Spain on penalty kicks, 3-0. In that shootout, seven total penalty kicks were taken, and in all seven the goalie dove to one side or the other. Two of Morocco's three penalty kick goals were struck straight down the middle.

In soccer, penalty kicks are converted approximately 80% of the time.[1] Defending against a penalty kick, the goalie is faced with a stressful, uphill battle and must make a split-second decision to stay put in the center of goal, jump left or jump right.

Behavioral economist Ofer Azar from Northwestern University collected data on more than 300 goalies and discovered that goalies who jumped left stopped just 14.2% of the shots, and those who jumped right stopped a mere 12.6%. However, goalies who stayed put in the center stopped goals 33.3% of the time. Amazingly though, goalies chose to stay put only 6% of the time.[2]

Azar interviewed the goalies about their decisions and found that emotions played an important role. The goalies revealed that they felt worse if the goal was made while they were standing still. In fact, taking action, even if it was likely to lead to failure, felt better for the goalies than taking no action at all.

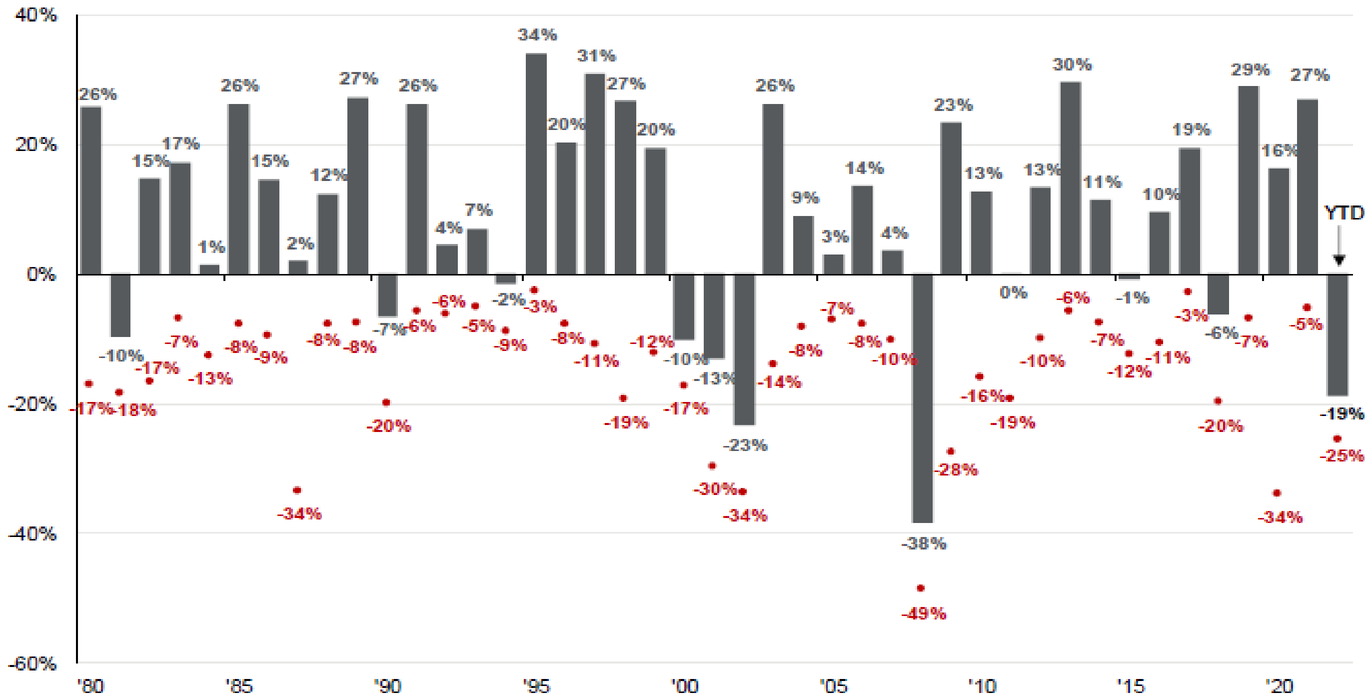
Azar applied his soccer research to investor behavior. He found that when the markets are in turmoil, we have a powerful urge to "do something" even when that "something" does not make sense. It relates to the “fight or flight” part of our brains. In the 2008 market turmoil, many investors gave in to the instinct to sell because it satisfied their desire for action. But those who stayed put benefited in the long run as the market recovered. We saw a similar yet quicker rebound following the pandemic downturn.

During times of market stress, it can be difficult and even seem counterintuitive to stay put, but that is often the best decision. Market volatility is normal and expected. We plan for it by building investment projections which incorporate the inevitable declines. When the declines come, we should not be shocked nor feel the need to “do something.” Additionally, the stock market has historically delivered strong returns in most years and, following losing years, it has recovered to a new high 100% of the time.

The chart below shows the high and low points of intra-year stock movements. It also shows that despite significant downturns, stocks deliver powerful returns over time. In fact, stocks have the best long-term returns of any asset class, including bonds, commodities and real estate. But stock returns are not free, and the price investors pay is volatility.

From this chart, it is easy to see why “market timing” is a seductive strategy. If we could sell stocks prior to a decline and hold cash instead, our long-run returns could be exponentially higher. However, successful market timing requires us to be correct twice: by determining when to sell stocks and when to buy them back. No one, including professionals, has proven they can do this consistently. Even Warren Buffet advises against market timing. Seeking to avoid short-term losses runs the risk of also missing larger long-term gains.

Annual Returns and Intra-Year Declines 1980 – 2022 [3]



Here is another reason to remain invested during a downturn. Historically, U.S. equity returns on average have been positive following sharp downturns. In fact, broad market index tracking data since 1926 shows that following a 20% market decline, U.S. stocks have returned 22.2% on average during the following year.[4] And five years following a 20% market decline, the cumulative return is 71.8%, an average annualized return of 14.4%.[4] Sticking with your plan puts you in the best position to capture the recovery.

Dramatic changes in security prices are not a sign that the financial system is broken but rather what we would expect when markets work properly. The world is an uncertain place. The role of security markets is to reflect both positive and negative developments in prices as quickly as possible.

Despite average intra-year drops of 14.0%, annual returns were positive in 32 of 42 years. [4]

Investors who accept dramatic price fluctuations as a healthy characteristic of liquid markets may have a distinct advantage over those who are easily frightened or confused by day-to-day changes. They are also more likely to achieve long-term investing success.

Corrections like the one experienced in 2022 are valuable in that they can help illuminate how we truly feel during periods of market-induced stress. By communicating these feelings to your advisor, you can fine tune your portfolio to target the highest possible return for your risk preference.

Notes and Acknowledgements:

1. “A Chart for Predicting Penalty Shoot-out Odds,” FiveThrityEight, July 1, 2014
2. Ofar Azar, Northwestern University, "On Second Thought: Outsmarting Your Mind's Hard-Wired Habits,“ Wray Herbert, 2010
3. "Annual Returns and Intra Year Declines", FactSet, Standard & Poor's, JP Morgan Asset Management, U.S. data as of December 31, 2022
4. “History Shows That Stock Gains Can Add Up After Sharp Declines”, Dimensional Fund Advisors, 2022, Sharper Granite data analysis 2022