

Fidelity Knowledge Centre: Volatility: looking through the noise

February 2018



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1. Introduction to volatility

Introduction to volatility

Looking through the noise



Volatility is an inherent feature of financial markets



- Markets always experience bouts of heightened volatility
- Market confidence can falter as a result of economic uncertainty, monetary or fiscal policy changes, financial contagion, geopolitical tension or simple shifts in investor sentiment
- Don't be put off by volatility. Volatile episodes can create attractive opportunities to buy assets at lower valuations

Ten key messages

1. Volatility is a normal part of long-term investing

- **Market volatility** is an inevitable and inherent part of investing
- It can be the result of investors (over)reacting to economic, political and corporate change
- **Mindset is key** - when we are prepared at the outset for episodes of volatility, we are more likely to react rationally and remain focused on our long-term goals



Warren Buffett

“

Unless you can watch your stock holding decline by 50% without becoming panic-stricken, you should not be in the stock market.

”

Ten key messages

2. Over the long term, equity risk is usually rewarded

Risk is not the same as volatility



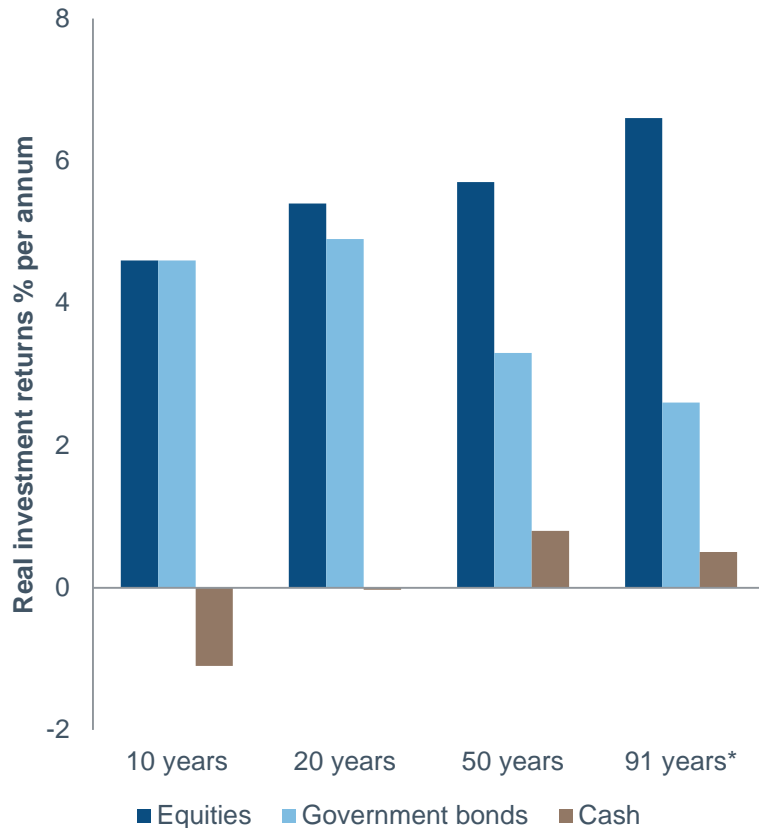
- Equity owners are typically rewarded for the extra risks they bear compared to investors in lower risk asset classes such as bonds
- Risk is not the same as volatility. Volatility refers merely to short term fluctuations in an asset's price. An investment can perform very well over the long term even if it is volatile in the short term
- At Fidelity, we recognise that markets are only semi-efficient. Investors' behavioural biases and emotions often cause asset prices to deviate from their intrinsic value
- In the long term, asset prices are driven by fundamentals (such as earnings) rather than emotion. Stocks have generally outperformed other asset classes such as bonds and cash in real terms over the long term.

Various asset classes carry different risk. For example, investing your money into stocks carry significantly more risk of loss to your capital than holding cash.

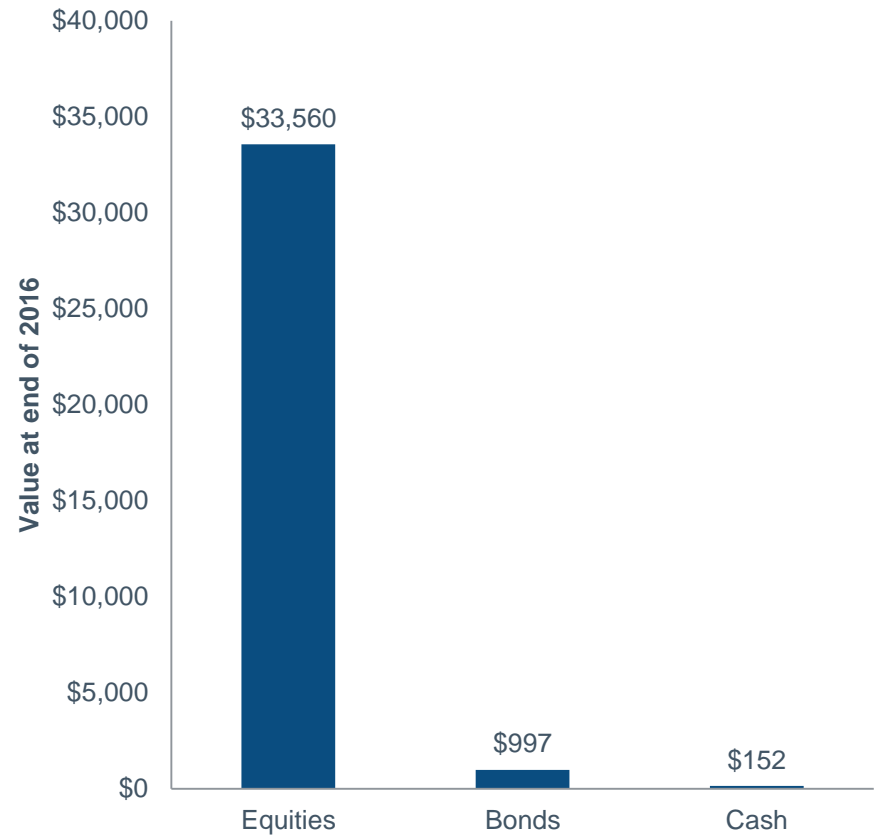
Ten key messages

2. Over the long term, equity risk is usually rewarded

Real investment returns by asset class
(% per annum) - US



Value of \$100 invested at the end of 1925 (as at end 2016) with income reinvested gross - US



* Entire sample. Source: Barclays Equity Gilt Study 2017

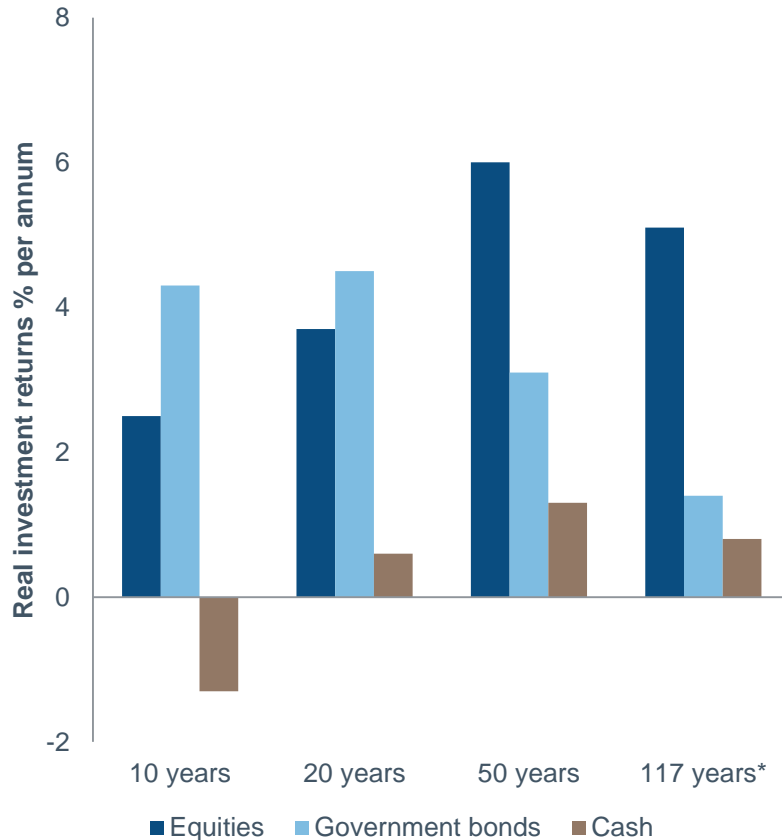
Source: Barclays Equity Gilt Study 2017

Various asset classes carry different risk. For example, investing your money into stocks carry significantly more risk of loss to your capital than holding cash.

Ten key messages

2. Over the long term, equity risk is usually rewarded

Real investment returns by asset class
(% per annum) - UK



* Entire sample. Source: Barclays Equity Gilt Study 2017

Value of £100 invested at the end of 1945 (as at end 2016) with income reinvested gross - UK



Source: Barclays Equity Gilt Study 2017

Various asset classes carry different risk. For example, investing your money into stocks carry significantly more risk of loss to your capital than holding cash.

Ten key messages

3. Market corrections can create attractive opportunities



Corrections are a normal part of bull markets.

They are often a good time to invest in equities as valuations become more attractive.

Corrections give investors the potential to capture returns.

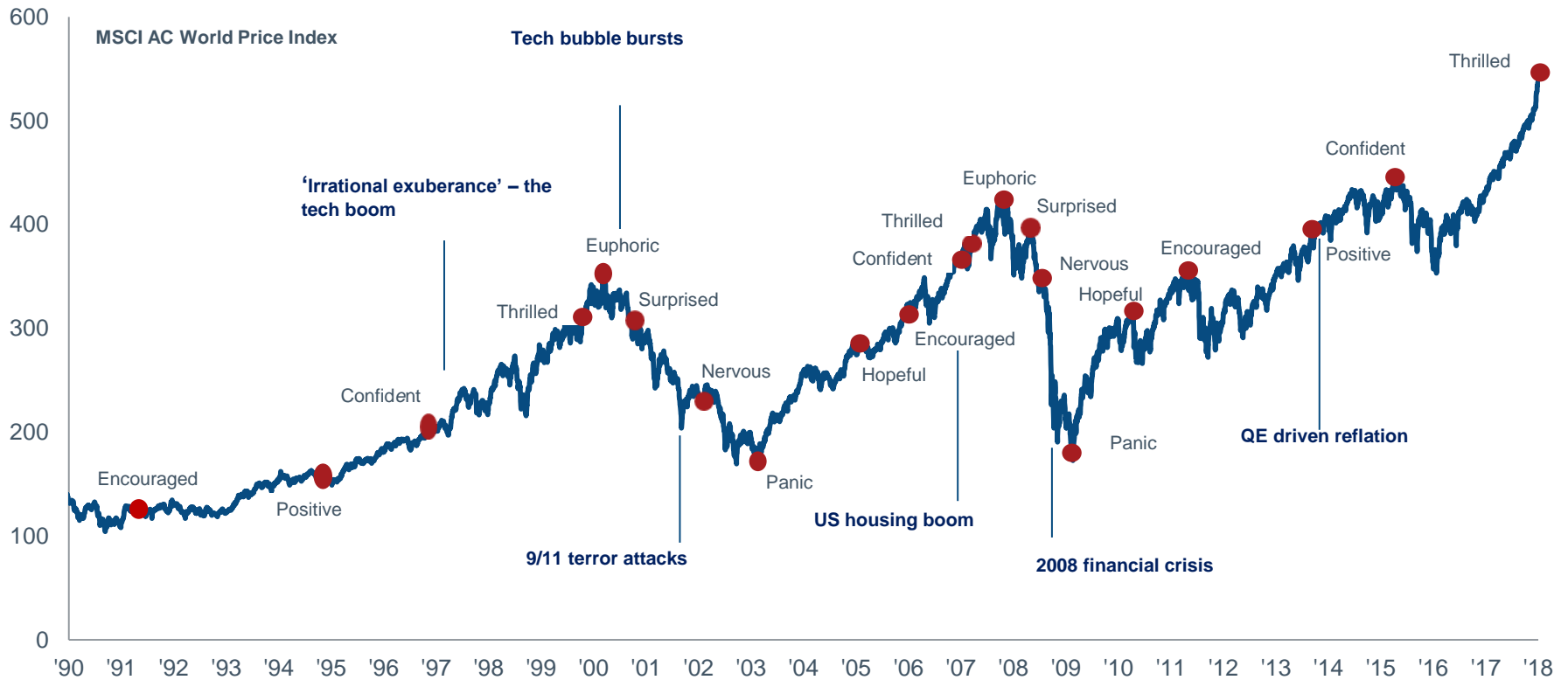


Source: Datastream, January 2018

Ten key messages

3. Market corrections can create attractive opportunities

How emotions can lead you astray: the MSCI AC World Index



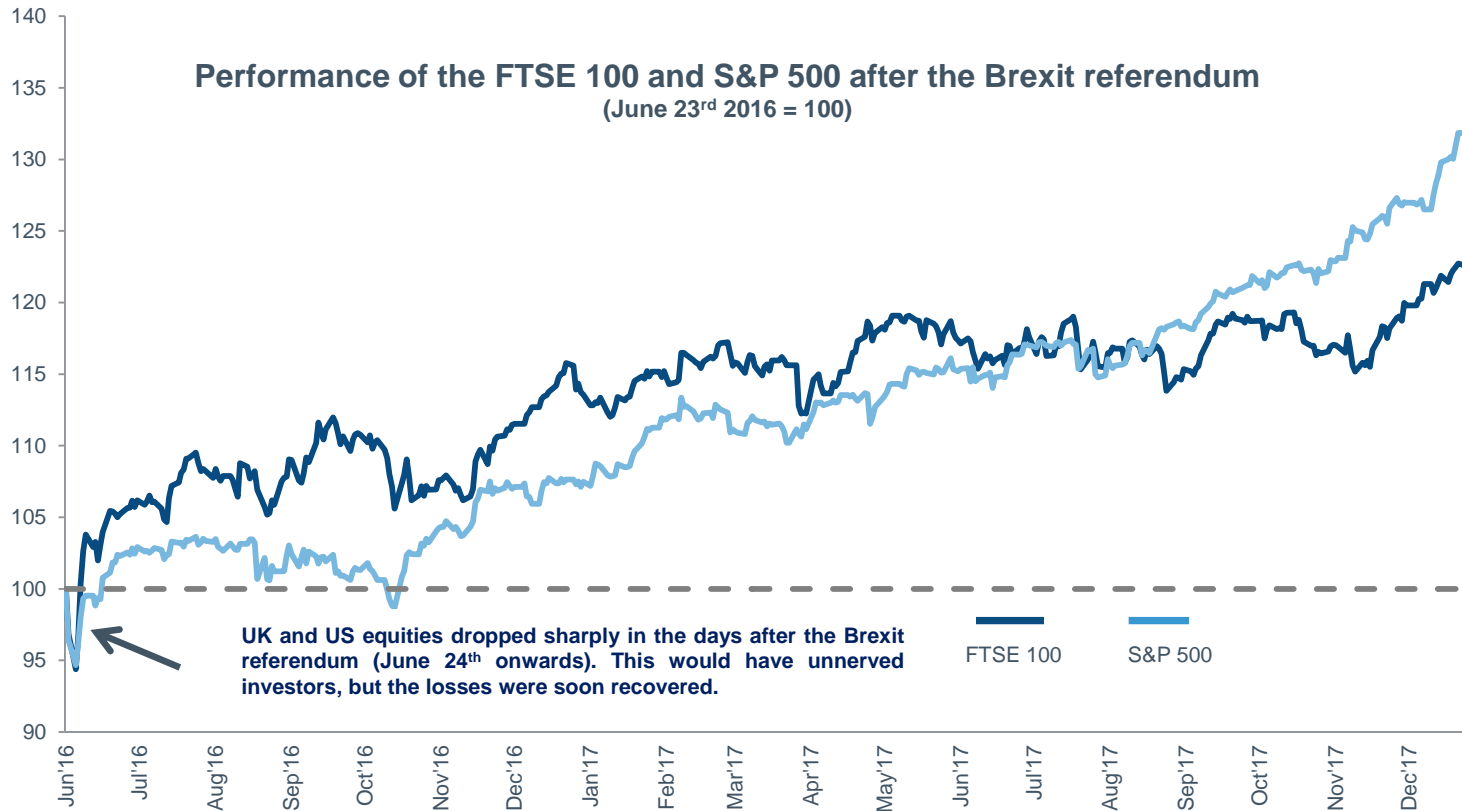
Stock market losses have often been followed by rebounds to new highs

Source: Datastream, January 2018

Ten key messages

3. Market corrections can create attractive opportunities

The Brexit vote is the most recent example of a high profile 'risk-off event'



Source: Datastream, January 2018

Selling just after Brexit has proven to be a mistake for investors

Ten key messages

4. Avoid stopping and starting investments

Those who remain invested during volatility may potentially benefit the market's long-term upward trend



Nassim Nicholas Taleb

Former options trader, and a leading thinker on risk. Author of *Foiled by Randomness* and *The Black Swan*.

“

When an investor focuses on short-term investments, he or she is observing the variability of the portfolio, not the returns – in short, being fooled by randomness.

”

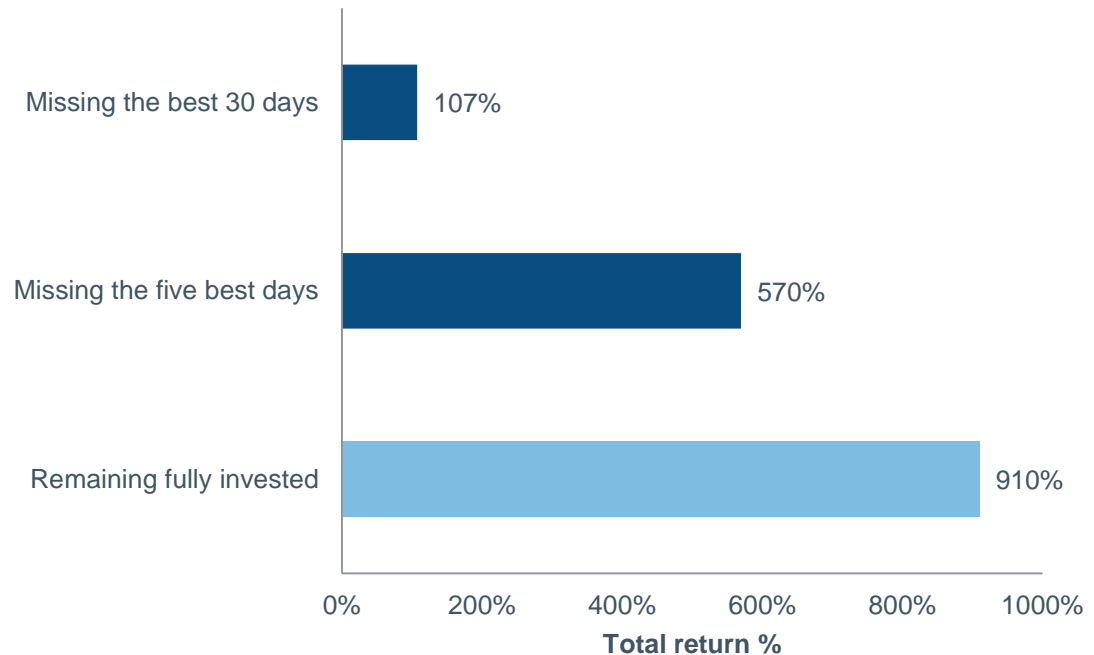
Ten key messages

4. Avoid stopping and starting investments



Missing the best days in the market can really impact longer term returns

Impact of missing the best 5 and 30 days in the S&P 500 (1992-2017)*, US\$



Source: Datastream, Fidelity International, February 2018.*Total return data from 31/12/1991 – 30/12/2017

Ten key messages

4. Avoid stopping and starting investments

The impact of missing the five or 30 best-performing days over the long term*

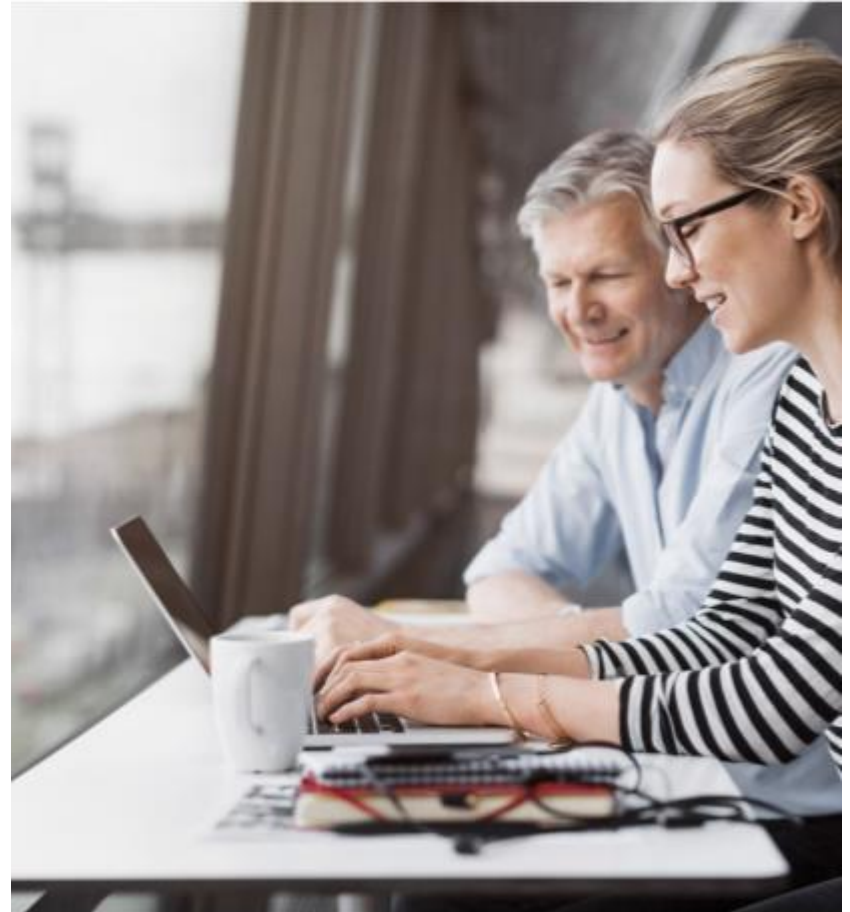
31/12/1992 to 31/12/2017	Total return for the entire period	Total return minus five best-performing days	Total return minus 30 best-performing days
CAC 40	524%	289%	-4%
DAX	736%	427%	25%
FTSE 100	552%	339%	47%
Hang Seng	1,177%	558%	23%
Nikkei 225	35%	-15%	-79%
S&P 500	910%	570%	107%
ASX 200	985%	730%	224%

Source: Datastream, Fidelity International, February 2018 *Period of analysis: 31/12/1992 – 30/12/2017. All calculations use local currency total returns, except for the Nikkei 225, for which the calculations are based on the price index

Ten key messages

5. The benefits of regular investing stack up

- Regularly investing a certain amount of money in markets is known as cost averaging
- While it doesn't promise a profit or protect against a market downturn, it does help investors to avoid investing at a single point in time, and can lower the average cost of their purchases



Ten key messages

5. The benefits of regular investing stack up



Investors should review their portfolio regularly

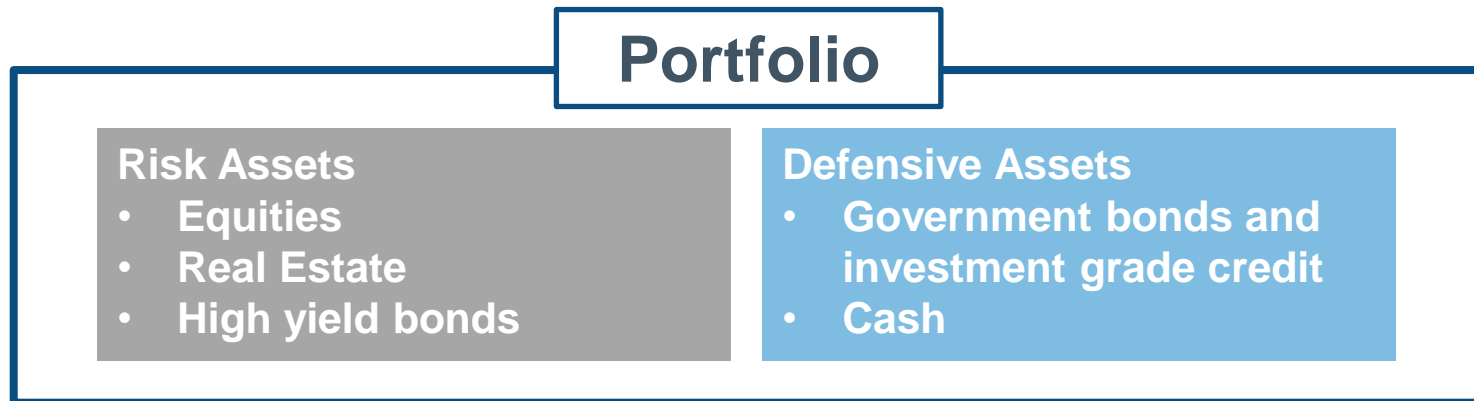
- Regular saving during a falling market may seem counter-intuitive to investors looking to limit their losses
- Yet some of the best investments can be made in a falling market when asset prices are lower. Buying assets cheaply helps to maximise an investor's benefit when markets potentially rebound



Ten key messages

6. Diversification of investments helps to smooth returns

- Asset allocation can be difficult to perfect as market cycles can be short and subject to bouts of volatility
- Investors can spread the risk associated with specific markets or sectors by investing into different investment buckets. This reduces the likelihood of concentrated losses

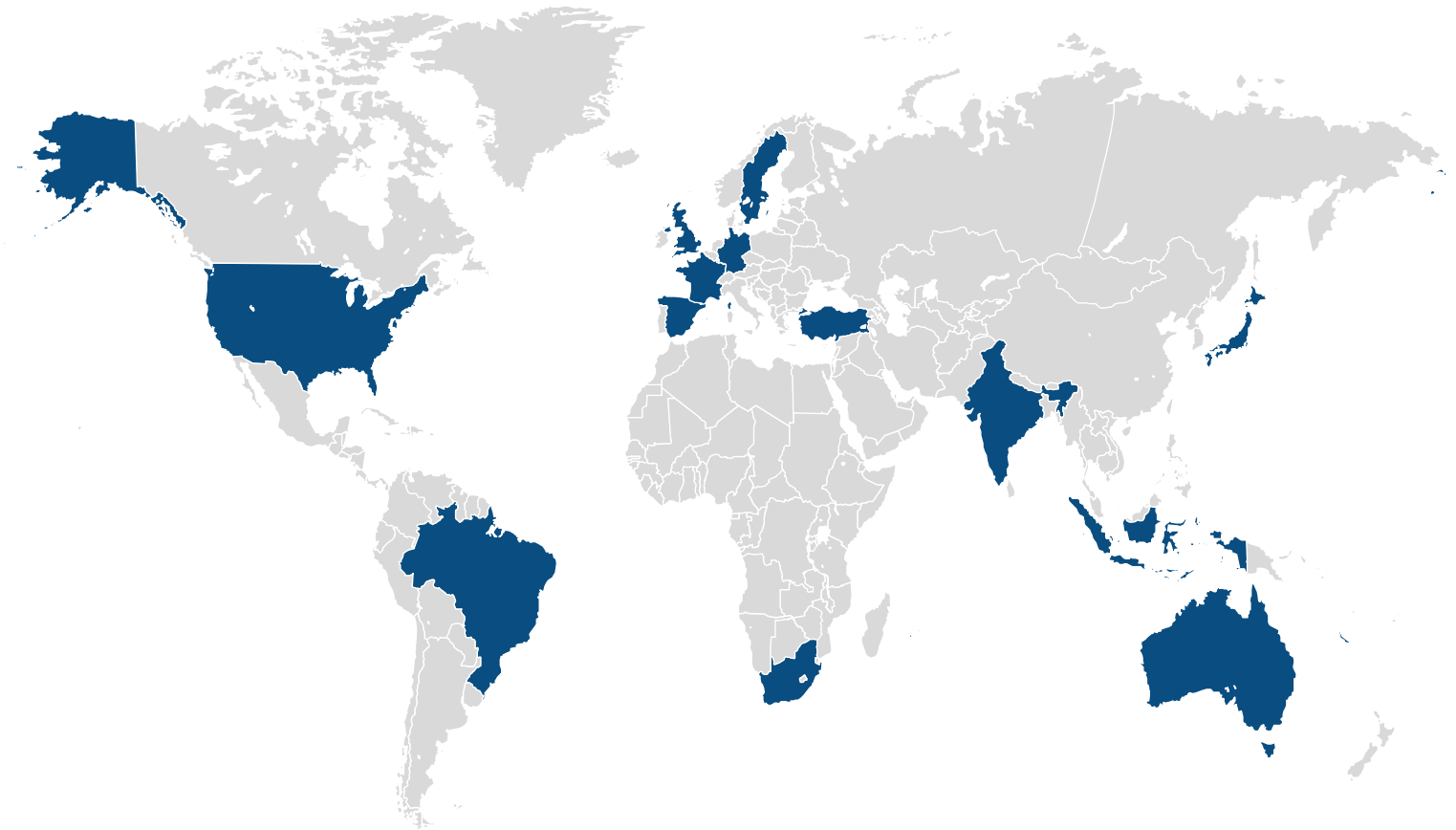


An active multi-asset fund may offer a ready-made diversified portfolio

Ten key messages

6. Diversification of investments helps to smooth returns

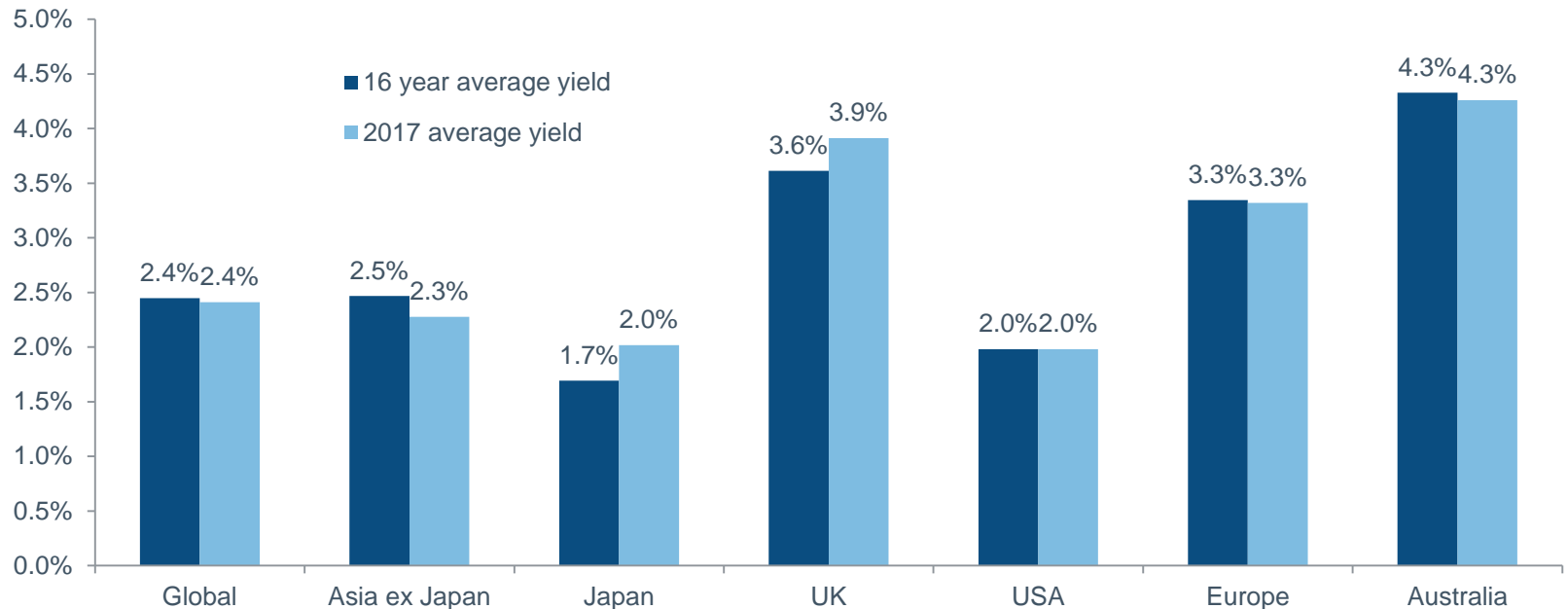
Spreading investments over different countries can also help to bring down correlations within a portfolio and reduce the impact of market-specific risk



Ten key messages

7. Invest in quality, income-paying stocks for regular income

- Sustainable dividends paid by high-quality, cash-generative companies are attractive during volatile market conditions because they can offer a regular source of income
- High-quality, income-paying stocks tend to be leading global brands that operate in multiple regions. These firms are well placed to perform robustly throughout business cycles
- This through-cycle ability to offer attractive total returns makes them a cornerstone for any portfolio

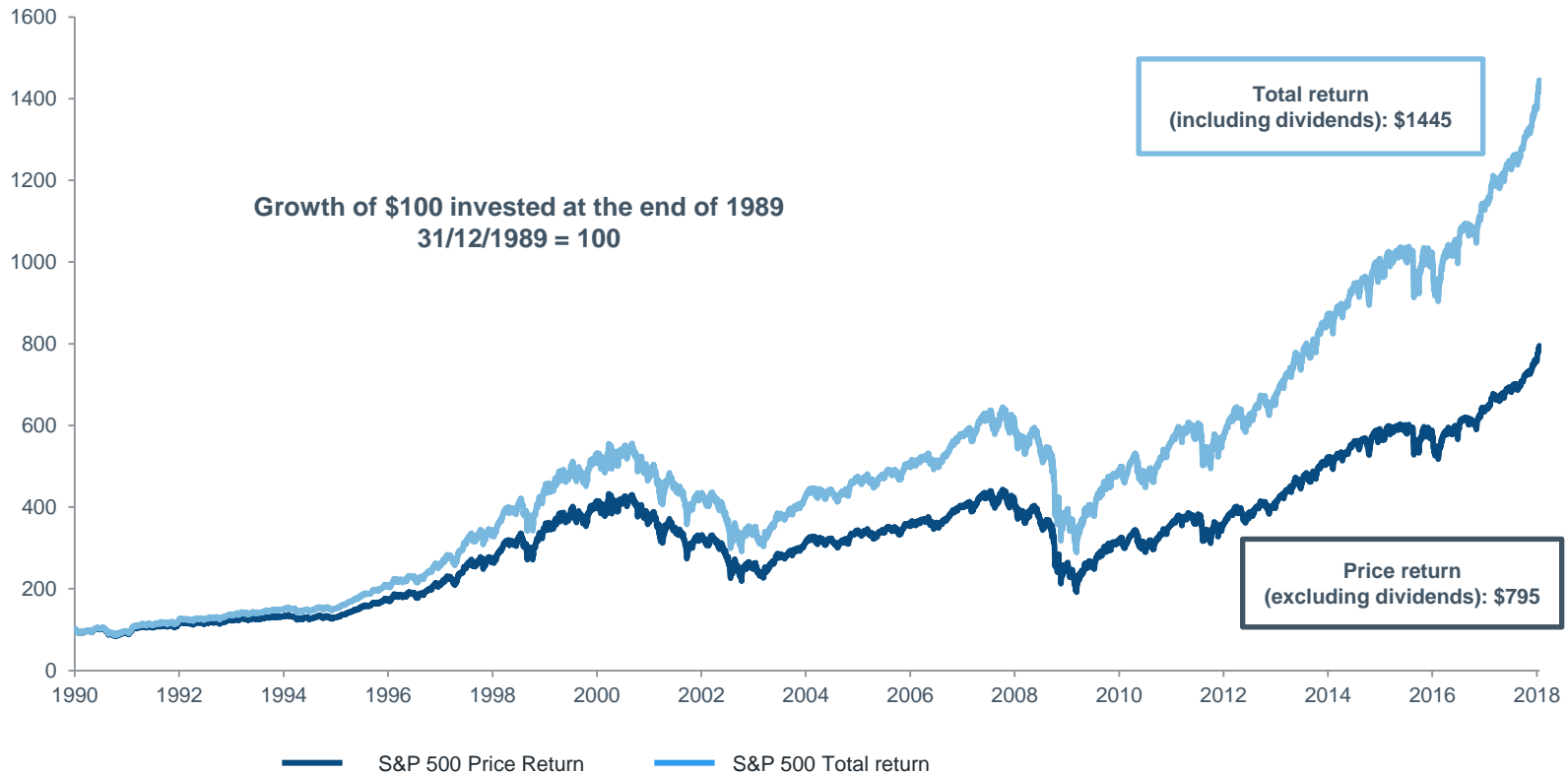


Source: Datastream, January 2018. Indices used: MSCI World, MSCI AC Asia Pacific ex Japan, MSCI Japan, FTSE All Share, STOXX Europe 50, Datastream Market US, Datastream Market Australia

Ten key messages

8. Reinvest income to increase total returns

Reinvesting dividends can provide a considerable boost to total returns over time thanks to the power of **compounding**



Time in the market is crucial

Source: Datastream, January 23, 2018. Returns calculated for the period 31/12/1989- 19/01/2018

Ten key messages

9. Don't be swayed by sweeping sentiment

- The popularity of investment themes **ebbs and flows**
- For example emerging markets and natural resources were 'hot' investment areas from 2003 to 2007
- Investors need to take a **discriminating view**. A top-down, passive approach to diverse areas like emerging markets is superficial
- There are great opportunities at the stock-specific level as innovative emerging companies take advantage of growing demand for healthcare, consumer goods, and other products and services



Don't allow the euphoria of the market to cloud your judgement.

Ten key messages

10. Active investment can potentially be a very successful strategy

Volatility means opportunities for bottom-up stock-pickers



- At Fidelity, we have one of the largest research teams of any asset manager.
- Because we analyse companies from the bottom up, we are well positioned to make attractive long-term investments, **especially when other investors are panicking during bouts of market volatility.**
- We add value not just by picking the winners but by avoiding the losers. The importance of these decisions is magnified over time, making active investing particularly appealing for long-term investors.

3. Lessons from Behavioural Finance

Lessons from Behavioural Finance

Thinking fast and slow

Thinking Fast: System 1

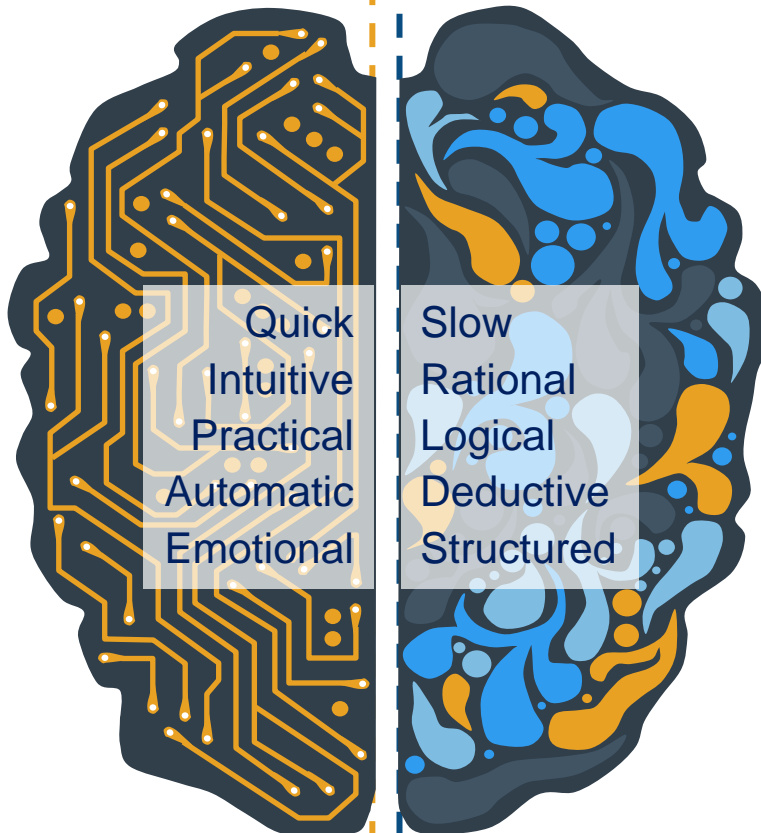
Quick, automatic,
intuitive and emotional

Default option for
information processing

Examples:

Detecting hostility in
someone's voice

Judging which object is
more distant



Thinking Slow: System 2

Slow, conscious, more
deductive and logical

Deliberate effort
required means we
often defer to System 1

Examples:

Parking in a narrow
space

Multiplying several
numbers

Source: Fidelity International; Daniel Kahneman, *Thinking Fast and Slow*

Lessons from Behavioural Finance

Some key behavioural biases

Herding

- One of the most serious investment implications of following the herd is that investors end up buying when prices are high and selling when prices are low
- This is called '**chasing the market**', and it's a terrible investment strategy. Investors can avoid herding by practicing cost averaging (making investments at regular intervals)

Loss Aversion

- Experiments show that humans feel the pain of a loss twice as deeply as the happiness from a gain. This is why it is so hard for most investors to stay in the market during periods of volatility



Lessons from Behavioural Finance

Loss aversion: 'Three strikes and I'm out'

Some investors sell at exactly the wrong time. The financial crisis of 2007-09 is a case in point.

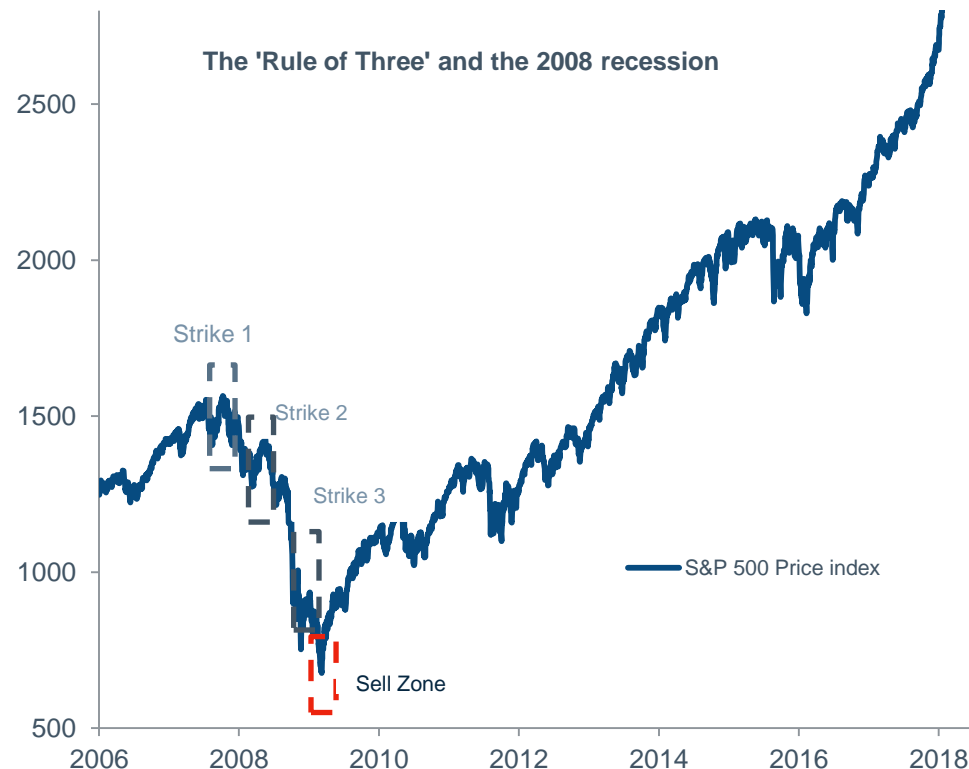
There is some evidence that investors use a rule of three in dealing with losses:

Strike 1: They are prepared to ride out the first correction in the market

Strike 2: They are pained by the second correction but hold on

Strike 3: Finally, they capitulate after the third wave of selling pressure

The irony is that some stock markets have often correct in three downward waves, meaning investors sell at the bottom. This is precisely the wrong time.



Source: Datastream, January 2018

4. What the experts say

What the Experts Say

These quotes from some of the most successful money managers illustrate how investing in stock markets can be a challenging yet rewarding venture requiring strong research skills, a rational, dispassionate mind-set, a long-term horizon, and patience.

Peter Lynch



“

Everyone has the brainpower to make money in stocks. Not everyone has the stomach. If you are **susceptible to selling everything in a panic**, you ought to **avoid stocks** and mutual funds **altogether**.

”

Sir John Templeton



“

Bull markets are born on pessimism, grow on scepticism, mature on optimism and die of euphoria.

”

What the Experts Say

Warren Buffett



“

You pay a very high price for a cheery consensus. It won't be the economy that will do in investors; it will be the investors themselves.

Uncertainty is actually the friend of the buyer of long-term values.

”

George Soros



“

If investing is entertaining, if you're having fun, you're probably not making any money. **Good investing is boring.**

”

Peter Lynch



“

Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves.

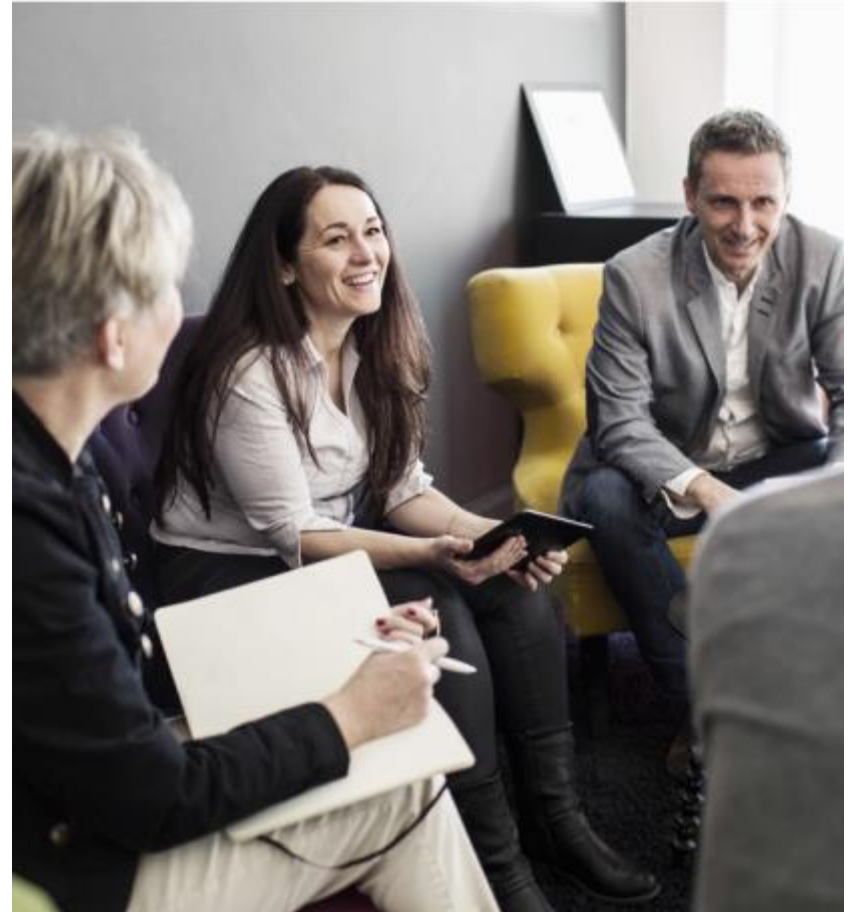
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5. Conclusion

Conclusion

10 things to remember when volatility strikes:

1. Volatility is a normal part of investing
2. Long-term investors are usually rewarded for taking equity risk
3. Market corrections can create attractive opportunities
4. Avoid stopping and starting investments
5. The benefits of regular investing stack up
6. Diversification of investments helps to smooth returns
7. A focus on income increases total returns
8. Investing in quality stocks delivers in the long run
9. Don't be swayed by sweeping sentiment
10. Active investment can be a very successful strategy



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