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The nation's retirement savings is under threat because of COVID-19. It's not just because many Australians have taken advantage of the interim 'early access to super' rules to tide them over during this crisis, but also because many investors are inadvertently making rash decisions about their investments outside super.

Matt Reynolds, investment director, at Capital Group, said that when investors see the value of their investments dwindling, their aversion to losses can compel them to sell at a loss and stay out of the market. This could prove damaging to their overall returns in the long term.

In this issue, Reynold explains why financial advisers have good reason to tell their clients to hold their nerve and allow the eventual market recovery, as proven in history, to steer their retirement plans back on track.

Michelle Baltazar
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Investing in volatile and disruptive times

After an extended bull run in global equities, financial markets are still coming to terms with the biggest shock since the global financial crisis. Concerns are high that the coronavirus outbreak will reverse economic growth and weigh on corporate profits for an indeterminate period.

In reality, the reaction of financial markets to the coronavirus pandemic is not the first bout of volatility investors have experienced during this extended bull run. It might be hard to recall, but global markets also saw a significant correction in 2018. As our chairman and chief executive officer Tim Armour remarked at the time: "The correction was overdue; the pullback didn't leave me overly concerned. Markets do better over the long-term when they experience corrections periodically; they can't go up all the time."

The volatility that we are experiencing now comes as markets were already nervous – about a slowdown in Chinese economic growth; heightened trade tensions between the US and China; political uncertainty in Europe; and the US presidential election later in 2020. In short, we are living in incredibly disruptive times – politically, economically and socially. And this disruptive environment is proving to be fertile ground for market volatility.

At Capital Group, we believe that for investors, one of the most important things to do during periods of volatility may also be one of the hardest – to contain your emotions. It's never easy to do this when markets are on the way up, and when they are on the way down. But we know through experience that it is the key to creating wealth over time.

Purely in an emotional sense, market volatility can create doubt in some, panic in others, and anxiety for nearly all.

When investors see the value of their portfolios diminishing, their aversion to losses and 'herd mentality' can compel them to follow the behavior of others and sell in a falling market. And once they have sold, many stay out of the market, feeling burnt by the experience. But that very reaction may cost investors dearly because those who sit on the sidelines risk losing out on periods of meaningful price appreciation that usually follow market downturns. Missing out on just a few trading days can have a significant impact on their financial retirement.

It is important to remember that time itself is one of the strongest factors in keeping the retirement picture intact. But staying invested requires a dispassionate and disciplined response to volatility.

Market corrections are not uncommon

History continues to show that market corrections of 10% or more are not uncommon. The MSCI All Country World Index (ACWI), for example, has had 40 such declines since 1970.

When investors see the value of their investments dwindling, their aversion to losses can compel them to sell at a loss and stay out of the market. But that can cost investors dearly over time. Why? Because, although no one can predict how long a decline will last (making it impossible to time the market), stock markets tend to have a reassuring history of recoveries.

To examine the potential implications of not staying the course, we analysed MSCI ACWI[1] data between 1970-2019, looking at the cumulative returns that would have been missed on average had investors with a particular loss aversion profile left the market[2]. While there was little meaningful impact one month later, the consequences were significant one, three and five years down the road.

For instance, a highly loss averse investor who rushed for the exit when the market dropped 10% and subsequently stayed out would have, on average, missed a cumulative return of 73% five years later. Investors with moderate or low loss aversion would have fared little better: they could have missed rebounds leading to returns of 68% and 53% respectively.

We also considered the same issue from a different perspective, keeping loss aversion constant and examining a wide spectrum of re-entry points over a 30-year period. The conclusion remained the same: the longer the investor waited to re-enter the market, the more damaging the potential consequences. In short, staying invested can help produce higher returns.

At Capital Group, we believe that being in the market and staying invested is what counts, and that buy-and-hold investors come out ahead over the long haul. This is easier said than done, however, which is why it is important that there are certain portfolios managed by skilled investment managers that are designed to limit downside risk and reduce volatility, both of which can help counter behavioural biases. These types of portfolios can help calm investor nerves when markets turn turbulent.

That is also why we at Capital Group stress a long-term perspective and the importance of preserving capital during downturns. We believe that by producing results that are less volatile than the broader market, investors are less likely to react to fluctuating market conditions by making short-term decisions with potentially destructive long-term consequences.

The quote

We believe that being in the market and staying invested is what counts.

It might not be an easy thing to do but it is well worth doing, so that investors can keep on track for the retirement that many of them have imagined. **FS**

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1 MSCI All Country World Index (ACWI) (net dividends reinvested) from 1 January 2001; previously MSCI ACWI (gross dividends) from 1 January 1988 and MSCI World Index (net dividends reinvested) from 1 January 1970.

2 We analysed multiple scenarios using a loss aversion ratio of 2.5 times and covered a total of 337 rolling periods. For the purpose of this study, we focused on three scenarios: investors with high (investor sells 50% of their portfolio when the market falls 10% and reinvests all the proceeds when the market rises 25% from its trough), moderate (investor sells 50% of their portfolio when the market falls 15% and reinvests all the proceeds when the market rises 37.5% from its trough) and low (investor sells 50% of their portfolio when the market falls 10% and reinvests all the proceeds when the market rises 50% from its trough) loss aversion, leading to high, moderate and low trading frequency respectively, which we compared with a buy-and-hold scenario.

The Capital Group companies manage equities through three investment divisions that make investment and proxy voting decisions independently. Fixed income investment professionals provide fixed income research and investment management across the Capital organisation; however, for securities with equity characteristics, they act solely on behalf of one of the three equity investment groups.

Watch the video on www.fsitv.com