What should investors do? Nothing! Just sit tight ....

From Mr Javier Estrada.

Sir, Many investors have been taken by surprise by last week’s huge swings in the markets. But they shouldn’t have been. As Benoît Mandelbrot taught us long ago, and Nassim Taleb popularised in his recent book *The Black Swan*, extreme returns are far more likely and have a much larger impact on portfolios than most people usually think.

On Black Monday (October 17 1987), the Dow fell 22.6 per cent and more than erased the return earned since the beginning of the year (201 trading days). It then took the Dow another 320 days to get past the level reached the day before the crash. Although Black Monday is an extreme example, it is indeed the case that a few large daily swings can more than overturn the return obtained over a long period of time.

Between 1969 and 2006, a passive investor in the UK would have turned £100 into £1,854 (without accounting for dividends). However, an investor who missed the best 10 (20) days would have seen his terminal wealth reduced to just £979 (£596), and one who avoided the worst 10 (20) days would have seen his terminal wealth increased to £3,819 (£6,063). That is particularly shocking given that 10 (20) days are just 0.1 per cent (0.2 per cent) of the days considered.

This and other similar results have at least three important lessons for investors. First, long-term performance is largely determined by the impact of very few outliers, like those observed last week. Second, investors are very unlikely to time the market successfully and consistently. And third, much like going to Las Vegas, market timing may be exciting but is not a good way to make money.

So what are investors to do, when faced with swings like those observed last week? Nothing! They should just keep their eyes on the long term (and off the prices flashing in the computer screen), and stay the course. And if they feel adventurous enough and want to play Indiana Jones, they should even increase their exposure to the market.

After all, that is just what Warren Buffett and other savvy long-term investors do every time the market takes a big dive.

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