How to Hold Your Nerves in Volatile Markets
Think About (Black)

BY JAVIER ESTRADA

Sometimes the facts are hard to accept, but that does not make them any less true. For instance, most investors do not like to accept that equity markets are nearly impossible to predict in the short term, but that does not make these markets any more predictable.

Most investors think they can avoid bear hugs by getting in and out of the market at the “right” times, but that does not make this unlikely idea any more plausible. Much like the children of Lake Wobegon, most investors think they are better than average. If only!

True, it is difficult to sit tight when a portfolio’s value erodes as rapidly as most portfolios did last year. Also true, it is easy to look at a price chart and pinpoint what would have been the good times to get in and out of the market. But just as true is the fact that hindsight is 20/20. It is easy now to say that it would have been a smart move to get out of the market at, the beginning of 2008, but it was not such an easy call to make back then.

Before you think “Here we go with another academic making an argument in favor of market efficiency…” let me hasten to say that that is not my goal here. Yes, I will defend the buy-and-hold strategy, but not with the usual academic arguments based on market efficiency and normally distributed returns. There is more than one road that leads to Rome, and more than one argument that leads to buy-and-hold.

My arguments will follow from my own research on black swans in financial markets.

BLACK SWANS IN FINANCIAL MARKETS

In a widely read book, The Black Swan, Nassim Taleb defines a black swan as an event with three characteristics. First, it is an outlier, lying outside of the realm of regular expectations because nothing in the past can convincingly point to its occurrence; second, it carries an extreme impact; and third, despite being an outlier, plausible explanations for its occurrence
can be found after the fact, thus giving it the appearance of being both explainable and predictable.

An example? Think about Black Monday. Between inception on May 26, 1896, and October 16, 1987, the Dow had only twice in its whole history fallen by more than 10% in one day. This happened on back-to-back days in the midst of the crash of 1929; on October 28, 1929 and October 29, 1929 when the Dow fell 12.8% and 11.7%. But nothing in the 90+ years of history of the Dow up to that time pointed to the possibility of a fall of the magnitude observed on October 19, 1987. Yet the unexpected and inconceivable did happen. Black Monday, when the Dow collapsed 22.6% in a single day, was an extremely rare event; it did have a very significant impact on investors’ portfolios; and many and varied stories were advanced to explain it afterward. In short, Black Monday was a black swan.

The black swan perspective of investing is based on three simple ideas. First, it is a fact that an extremely small number of days have a massive impact on long-term performance. Second, although being invested on the “good” days and not invested on the “bad” days would yield extraordinary returns, investors are very unlikely to get the timing consistently right. And third, because market timing is bound to fail, most investors are better off holding a properly diversified portfolio for the long term.

Let me give you some evidence on the first two points. My own research shows that, across 15 developed markets, missing the best 10 days would have resulted in portfolios 51% less valuable than a passive investment, and avoiding the worst 10 days would have resulted in portfolios 150% more valuable than a passive investment.\(^1\) Given that 10 days represent less than 0.1% of the holding period (10,685 days) in the average market I considered, an obvious conclusion follows: A negligible proportion of days determines a massive creation or destruction of wealth; hence, the odds of successfully and consistently predicting the right days to be in and out of the market are nil.

In emerging markets, the impact of outliers is even larger. My own research shows that, across 16 emerging markets, missing the best 10 days would have resulted in portfolios 69% less valuable than a passive investment and avoiding the worst 10 days would have resulted in portfolios 337% more valuable than a passive investment. Given that 10 days represent less than 0.15% of the holding period (7,186 days) in the average market I considered, the conclusion above is further strengthened: The probability of successfully and consistently getting the timing right is negligible.

Brokers, of course, may try to tell you otherwise so keep in mind two things. First, the figures above are comprehensive facts, not theories. Second, brokers are cheerleaders of high turnover and unlikely to discourage any client from buying and selling frequently. But do not blame them entirely; after all, what would you do if your bonus depended not on the profits of your clients but on the commissions of their trading? Exactly.

Investors, on the other hand, cannot be blamed entirely for believing they can outsmart the rest of the market; after all, it is difficult to walk into a bookstore without being seduced by stacks of books with flashy covers that promise "high return, low risk" strategies. But ask yourself, if you had found a strategy to make a killing in the market, would you use it to make money for yourself or write a book and tell everybody about it? Exactly.

**SHORT-TERM PAIN, LONG-TERM RETURNS**

At the end of the day, the only way to obtain high long-term returns is to suffer some short-term pain. And although we can always attempt to quantify the latter, it is ultimately related to how well investors can sleep at night, and how long they can go without worrying about the value of their portfolio. Unfortunately, the "no pain, no gain" rule applies to investing too.

I run a program on portfolio management that aims to give unsophisticated investors some basic tools to manage their savings. During the program I tell participants about what I call the two "sad truths" of financial markets. The first is that the higher the required return, the higher must be the exposure to risk; the second is that the higher the exposure to risk, the longer must be the investment horizon. I usually see them nodding when I talk about this, but as soon as the coffee break starts they ask me whether they should buy this or that stock or whether the euro is going up or down. Oh well, I cannot be blamed for not trying. ...

There must be something about financial markets that makes them look easy to predict, even to outsiders. But I confess that I have no idea what it is. It cannot be the record of professional money managers, whose ability to beat their benchmarks is, at best, questionable. If those who are paid a great deal of money to beat a stated benchmark have a very hard time doing it, and almost nobody does it consistently over time, why would someone with little expertise, information, and time to manage his portfolio do any better? I have no idea.

Perhaps some people think that trading is fun; and it may well be, but as a pastime it may end up being a very expensive one. Just consider the performance of the S&P 500 this year. Between the beginning of 2009 and March 9, the S&P fell 25.1%; and between March 9 and the end of April, it increased by 29%. Trying to profit from such a high volatility may sound tempting, but

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more likely than not investors will not be able to get the timing right, all the while still paying the transaction costs of their trading.

For this reason, even if they do not really believe in the two “sad truths” mentioned previously, at least investors should act as if they believed them. That would lead them to stop trying to have the “best” portfolio at each point in time and to focus instead on what is really important: asset allocation and rebalancing. The first consists of deciding the desired proportions of the main asset classes in the portfolio; the latter consists of periodically bringing the portfolio back to those desired proportions.

Many studies show that over 90% of the performance of portfolios follows from asset allocation; market timing and security selection within each asset class together account for less than 10% of performance, at best. Finally, investors should focus on costs.

Financial markets currently offer a wide variety of instruments that enable more or less the same exposure to any desired benchmark. But, more important, some instruments are far cheaper than others; index funds and ETFs provide the lowest-cost exposure to just about any desired level of risk and should form the core of most investors’ portfolios.

In short, black swans do exist, both in nature and in financial markets. The former may be just a curiosity to most people; the latter, in turn, have critical implications for investors. Black swans suggest to investors both what not to do (engaging in futile market timing) and what to do (diversifying the portfolio and holding it for the long term). And that is far more than you can learn from many expensive financial advisors.

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