Key Questions

How Should Investors Navigate Volatile Markets?

March 9, 2020

Daniel Fiedler, CFA®, Portfolio Manager
George Mateyo, Chief Investment Officer

Investors should control what they can control.

As the spread of the coronavirus and its related disease COVID-19 expands rapidly beyond China and financial markets gyrate wildly, investors' collective nerves have been understandably shaken over the past several weeks. Adding to the level of anxiety is that, no one can precisely predict how the situation will unfold in the coming months.

The purpose of this article is to step back and provide some suggestions as to how investors might navigate volatile markets. Nothing written below is meant to downplay the human toll of the virus, but we hope these insights will prove instructive during these uncertain times.

First, it is important to recognize that what we are experiencing is both unprecedented and abnormal. Last week, the US 10-year Treasury yield broke sharply below 1% for the first time in its history as investors sought safety amid concerns over an impending virus-related economic slowdown. Just how severe the economic impact will be is also unknowable, further fueling investors' unease.

Two, over the last two weeks, stocks have oscillated wildly with average swings of +/-3%, volatility that was last present during the height of the Global Financial Crisis in the fourth quarter of 2008. Similarly, other risk indicators such as the volatility index (VIX) and credit spreads have spiked.

Importantly, while the economic hit may be severe and a new normal may emerge, history tells us that this crisis will pass. All crises do eventually end; while in some instances the adjustments may be painful, markets adapt and societies endure.

As we are living through it, however, we feel compelled to act in response to the markets' gyrations. Yet again, history is against those who attempt to nimbly exit the market as it's falling and then quickly re-engage before the market recovers.

Staying the course might sound too simplistic or unresponsive, but it is a preferred approach as opposed to market timing, from our perspective. This can be evidenced by last week's market action that featured steep corrections one day followed by swift recoveries the next.

Staying the course is made easier by carefully constructing an investment plan that incorporates periods of volatility and contemplates the possibility of drawdowns. Such a plan usually takes the form of a written Investment Policy Statement (IPS). This document, ideally fashioned in conjunction with your Portfolio Strategist during a period of relative market calm, may serve as a reassuring guide during times of heightened volatility.

Supplementing your IPS is a comprehensive financial plan that may quantify specific liquidity requirements. Against these liquidity needs, we recommend that investors maintain 6-12 months' worth of spending commitments in cash equivalents followed by an additional 12-18 months' worth of obligations invested in high-quality fixed income securities.

Spending levels will obviously affect liquidity requirements. Key Private Bank's Key Wealth Direction® platform allows the aggregation of financial accounts (including credit cards and monthly bills) from multiple institutions. This service is a great way to get a handle on your monthly net cash flow.

Another crucial piece of the puzzle is risk tolerance. The worst time to learn your true risk tolerance is during a crisis. If the past few weeks have caused you elevated levels of stress, it is probably prudent to re-examine your existing asset allocation strategy. Conversely, if you are feeling at relative ease and don't feel the need to alter your financial plan or lifestyle, rebalancing away from assets that have outperformed (such as fixed income) and into assets that have declined in value (such as equities) is another strategy that has been rewarded over time.

Lastly, we believe it is important that investors know what they own, and why they own it. This speaks to the importance of portfolio construction. It also speaks to the notion that investors need to know themselves.

We don't purport to know the future. We can, however, maintain control over our own actions and practicing rational, non-emotional behavior. By focusing on the long-term and maintaining ample liquidity amongst a diverse portfolio of assets, investors can mitigate some of the behavioral risk that comes with volatile markets. This can be better achieved by creating and referring to a written IPS. As legendary investor Charley Ellis once said: "A policy is a prescription for panic".

That's sound advice in any market.

For more information, please contact your Key Private Bank Advisor.

Publish Date: March 9, 2020