# Investment Insight

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## Volatility returns in 2018?

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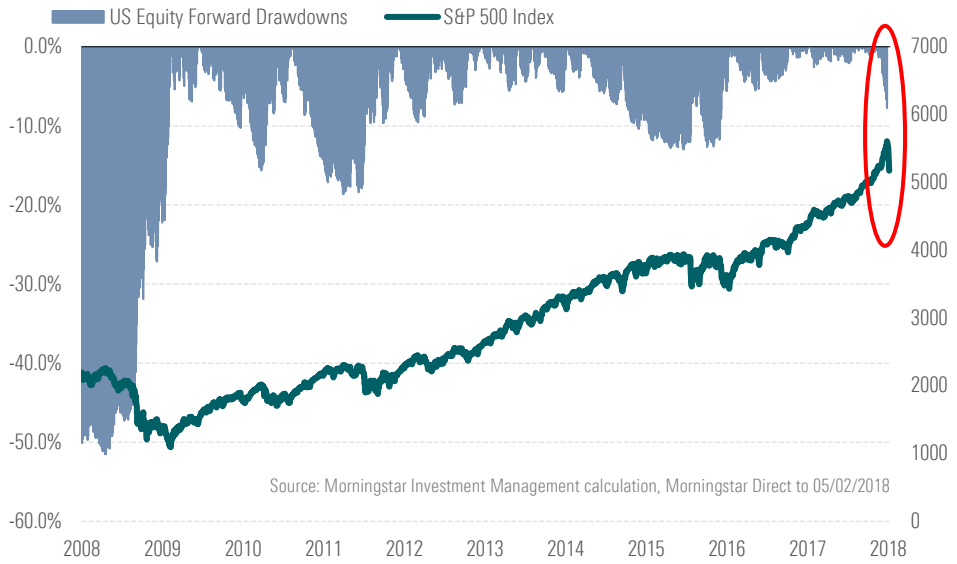
**What is the catalyst behind the correction?**

If one ever wanted evidence to support behavioural finance, the recent sell off must be it. It has long been said that when the US sneezes, the rest of the world catches a cold; and that has certainly proved to be true this week as a fall in the US stock market triggered a global equity downturn.

In fact, US stocks listed on the Dow Jones, S&P 500 and tech-focused Nasdaq markets have all fallen since their all-time highs late last month, with an official "correction" of 10% not far away. Yet ironically, if market headlines are to be believed, this was in reaction to stronger employment figures released last Friday, where the market is now thought to be concerned that the jobs figures are too good and will force the central bank to raise interest rates faster and higher than predicted.

Following the swift change in sentiment, global markets have fallen sharply, with European and Asian markets deteriorating amid the volatility spike. Making headlines are the short-term moves in Japanese equities, falling by nearly 5% from peak to trough, while the FTSE is down almost 6%, Europe down 5%, Emerging Markets by approximately 4%, in local currency terms, and the Australian market down more than 3%.

**Exhibit 1** The U.S. equity decline in perspective.




The above chart looks at how far the U.S. market has fallen in times of market stress, and how long it took to recover in value. In this respect, it's worth observing that, firstly, there have been very few periods of genuine market stress over the last couple of years and,

secondly, in the context of history, the magnitude of losses are less significant.

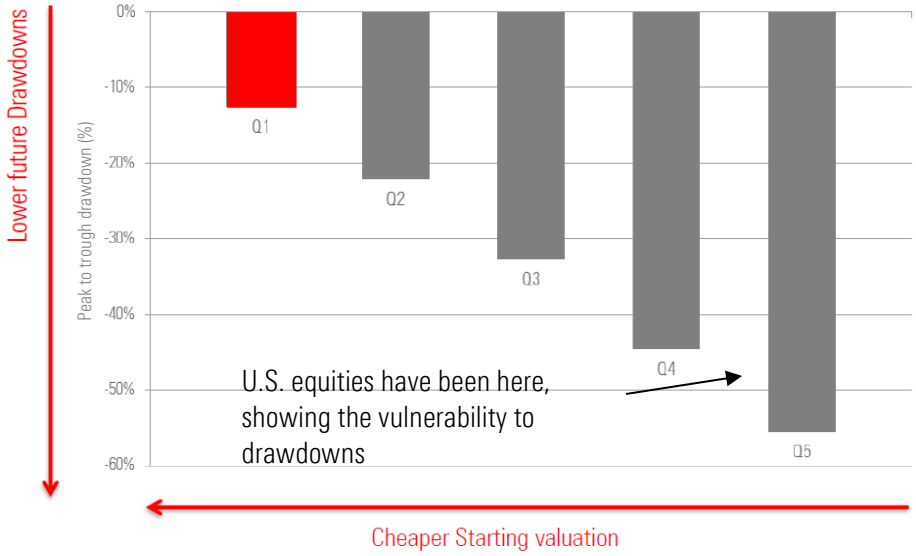
Bond markets have also experienced heightened volatility, with interest rates on 10-year Treasury bonds rising rather sharply on Friday (to 2.84%), only to reverse on Monday as investors rushed to take advantage of the lower price and higher yield. This phenomenon was extended globally – and among currencies – as investors attempt to make sense of the ramifications of strong wage growth and the potential for higher inflation.

**How should an investor interpret this?**

By applying perspective, one must remember that the jobs figures showed the highest wage growth in eight years, not the weakest. So, it seems rather ironic that it was the sole catalyst for investor panic, as it is something the market had desired for so long. This highlights how hard it is to explain sentimental shifts and reinforces the need to focus on valuations.

Therefore, under this framework, it is important to look through why the investor reaction was so pronounced, which is best considered under the lens of price versus fundamental change. For example, is the market reaction more to do with the nervousness extending from the stellar bull market of 2009-2017? Or can we expect a material impact to corporate profitability? While we are not in the business of forecasting short-term sentiment, we can look at current prices, where U.S. equities have been considered as overvalued for some time now. We can also apply thought to the evidence, which overwhelming shows that prices are more likely to fall back in line with fundamentals, especially when prices run well ahead of intrinsic value.

**Exhibit 2** Protecting capital has been a strength of valuation metrics such as the CAPE ratio.




Source: Morningstar Investment Management calculation, Shiller data from 30/06/1891 to 30/06/14

In appraising the above, we are reminded of the following quotes:

*"The ability to focus attention on important things is a defining characteristic of intelligence"* – Robert Shiller

*"Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing"* – Warren Buffett

*"Bull markets are born in pessimism, grow on scepticism, mature on optimism and die on euphoria"* – Sir John Templeton

**What course of action will Morningstar take?**

Before being tempted to act, one way or the other, it should be acknowledged that periods of market turbulence can be especially dangerous for investors as they tend to elicit an emotional response and heighten the behavioural biases to which we are all prone. Left unchecked, these biases can lead to us making poor decisions which can harm long term investment returns.

We therefore need to find a way to overcome these biases, which should include the following:

- First, remember that investment is a long-term pursuit and put all recent price movements in this context. While a 5-10% fall may feel a lot, it means little in the context of a 10-year investment horizon.
- Second, try to avoid the sensational headlines that can lure you in to action. It is normally better to read books than listen to forecasts.
- Third, if you are going to look for opportunities, ensure that you have a robust framework for assessing the real value of assets. This will put the wage growth in perspective, providing an anchor for your expectations and help you avoid over-reacting to short-term price movement.

The Morningstar Investment Management team will be spending the next days, weeks and months watching the developments closely in this context. However, we will be focusing on the same principles as we would any other period; assessing the value of each asset class, digging into the fundamental drivers of returns and challenging the fear/greed corollaries that we are all behaviourally exposed to. Furthermore, we will do so under our committee structure, where we can challenge each other's views and make sound long-term decisions that utilise deep and thoughtful analysis.

We note that Morningstar's portfolios have generally had elevated levels of cash in response to the stretched valuations. While this should act as a buffer against the current volatility, it may also provide ammunition should any exemplary opportunities present themselves.

In bringing this together, we appreciate that many are nervous about the current market conditions, yet it is important that we stick to our plan and focus intently on the objective at hand. We similarly advocate that one remembers the tenets of great investing; to be thoughtful, be long-term focused and be willing to challenge our own behavioural biases. While this is nowhere near as exciting as making quickfire trading decisions, it reflects our observation of how the most successful investors operate.

If you would like further supporting material, we have an abundance that we are willing to share. As always, we welcome any comments or queries and encourage you to speak to your local relationship manager. **M**

# Morningstar's Investment Principles

**We put investors first.** We believe the firms that put investors first win in the long term because their investors win.

Since 1984, Morningstar, Inc. has been helping investors reach their financial goals. Our fiduciary duty to our principals is paramount.

**We're independent-minded.** To deliver results, we think it's necessary to invest with conviction, even when it means standing apart from the crowd.

Our research shows that making decisions based on fundamental analysis, rather than short-term factors and sentiment, delivers better long-term investment results.

**We invest for the long term.** Taking a patient, long-term view helps people ride out the market's ups and downs and take advantage of opportunities when they arise.

Investing with a multi decade horizon aligns with investors focus on increasing their purchasing power over their lifetimes.

The long term is the only period where fundamental, valuation driven investing works.

**We're valuation-driven investors.** Anchoring decisions to an investment's fair value—or what it's really worth—can lead to greater potential for returns.

Valuation-driven investing through a long-term focus on the difference between price and intrinsic value enables investors to get more than they're paying for.

**We take a fundamental approach.** Powerful research is behind each decision we hold, and we understand what drives each investment we analyse.

Fundamental investing incorporates a focus on the future earnings of an investment and not its prospective price change.

**We strive to minimise costs.** Controlling costs helps investors build wealth by keeping more of what they earn.

Investment returns are uncertain, but costs are not.

Lower costs allow investors to keep more of their returns.

**We build portfolios holistically.** To help manage risk and deliver better returns, truly diversified portfolios combine investments with different underlying drivers.

Portfolios should be more than the sum of their parts.

True diversification can have a powerful impact on a portfolio's risk-adjusted returns – but simply holding more investments isn't the same as true diversification.