Understanding Volatility

"The True Investor Welcomes Volatility."

\- Warren Buffet

Everywhere you go, the daily volatility of the stock market seems to be a common topic of conversation. But talking about the market was not always this popular. Prior to the launch of financial news channels on cable TV in 1989, the only way most people knew what was happening in the stock market was to see it on one of the three evening network news shows or read about it in the newspaper. The only major TV show that focused exclusively on investment topics was *Wall $treet Week* with the inimitable Louis Rukeyser. This show aired on Friday evenings for 32 years and for most of that era it was generally understood that one hour per week was just about all the stock market news that anyone could need or even tolerate.

The situation is very different today. News about the stock market is everywhere, especially when the market is volatile. The daily price fluctuations of quoted shares from China to Europe to the US can be seen on cable TV, the internet, and our ubiquitous handheld devices. In calm market environments market news is more like a quiet but constant hum in the background, but when the market suddenly turns volatile it becomes a hot topic of conversation.

The problem is, the constant noise of price volatility has an adverse impact on your psyche. For example, there is a human tendency known as "activity bias", which leads individuals to want to be active in times of stress, even if that activity is counter-productive. People also exhibit "trend-following" behavior, which leads one to believe that the future will resemble the recent past, even if there is no rational basis for that belief. These tendencies have been helpful in our evolutionary past, but they are not helpful in an environment in which we are inundated with information about the volatility of the stock market.

It is easy to see how these biases can lead to negative outcomes for investors. If stocks have been falling recently, the constant reminder of decreasing wealth pulsing through an investor's iPhone causes stress, which triggers his activity bias to shout "do something!" Then his trend-following tendency kicks in, convincing him that the market can only go lower for the foreseeable future, and he decides to sell in a panic, often right before the market turns in a positive direction.

The irony of this is, if we had *less* frequent access to stock price information, these harmful behavioral tendencies would be dormant and we would be able to make better long-term investment decisions. As a counter-example, consider a privately-held family business: The actual intrinsic value of that business fluctuates daily based upon revenues, costs, the selling price of comparable businesses, and a variety of other factors. Yet the owner of that family business is not obsessed with the volatility in its value *because the price fluctuation is not identified and presented every day.* The

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owner does not even consider selling the business due to volatility; she views the business as a long-term investment and recognizes that it will likely be worth more in the future.

And what about your primary residence? Due to changes in interest rates, inflation expectations, and the sale price of the house next door, the actual value of your home or any investment real estate that you own fluctuates on a daily basis as well. Yet the thought of selling your home due to the daily volatility in its value has probably never even occurred to you. Instead, you view real estate as a long-term investment and recognize that it will likely be worth more in the future.

Visible stock market volatility is no different from the invisible volatility of real estate or a family business, and you should regard daily stock market movements as no more than a unique and noisy nuisance along the path to the long-term appreciation of your assets. However, the nuisance of the news is not going away, and those human behavioral tendencies are impossible to shake off. So, how can you fight the emotional responses to volatility?

First, change the channel. For anyone other than a professional stock trader, the ability to view second-by-second pricing is a curse and you should avoid it because it is irrelevant to someone with a long-term perspective. Replace the loudmouth banter of CNBC with re-runs of The Crocodile Hunter on Animal Planet, and disable the real-time market quotes on your smart phone. This will help your investment results, lower your stress level, and quite possibly make you a calmer person.

Second, never make an investment decision, especially a decision to sell, while the market is open. Part of the reason you do not consider selling your home or small business due to price volatility is that it is not easy to do so. But now that stock trading fees are very low and on-line trading is accessible to everyone, it is very tempting to trade stocks quickly *because it is very easy to trade stocks quickly*. Instead of having activity bias lead you to make rash investment decisions, contemplate your decisions in a calm setting while the market is closed and use measured reason rather than impulse and emotion as your guide.

While advances in technology and greater access to information have provided many benefits, we do sometimes miss the days when sparse information and cumbersome trade processes served as a barrier to some of the rash decisions that investors are prone to make. Instead of getting caught-up in the daily volatility of the markets, it would be helpful to accept volatility as a fact of life and recognize that the bumpy ride that stocks sometimes give you will be rewarded with higher expected returns in the long-run.

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