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WEALTH MANAGEMENT

MARKET STRATEGY
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The Benefits of Staying Invested During Times of Market Turbulence

The S&P 500 has fluctuated wildly over the past several months, moving from a high near 2940 in mid-September to approximately 2600 in late October, back over 2800 in early November, and now again near 2600. When markets behave in this manner, an investor's likely first response is fear. Fear is our pre-programmed, evolutionary response to uncertainty. We take in stimuli from the outside world and process it quickly. In his book *Thinking, Fast and Slow*, psychologist Daniel Kahneman calls this our System 1 thinking. System 1 was particularly useful for our ancient ancestors, helping to prevent them from getting eaten by the lions chasing them out on the plain. However, it is less useful in helping investors to achieve long-term financial goals. In fact, within the context of our financial decision making process, System 1 can do just the opposite – deliver us safely from the lion by sending us running off of a cliff.

System 2, Kahneman's term for our deliberative thought process, integrates subjectivity into our decision-making process, allowing us to deal with complex problems that are uniquely human. Unfortunately, System 2 is disrupted when our attention is diverted. As Kahneman says in the book, "you must pay attention…you will perform less well, or not at all, if you are not ready." In this market environment, System 1 is working hard to convince us that the latest move of the financial markets is the impeding lion. **In reality, minute-by-minute monitoring of daily market movements serves as a distraction for individual investors with a sound financial plan, and impulsive actions undertaken during these times of market stress can often do more harm than good.**

Like all humans, the D. A. Davidson Wealth Management Research team is susceptible to distraction. Our team combats this distraction by employing a disciplined investment process that helps focus on the long-term strategic goals of our clients. First, we view stocks as ownership of underlying businesses that have intrinsic value. This means that one hundred shares of a stock owned in our portfolio today has the same value regardless of whether the market says it is currently worth $10 or $75. The belief in intrinsic value helps to combat one key question asked by our System 1 investor selves – "should I be in or out of the stock market?" Without a belief in intrinsic value, this would be a relevant question as stocks are worth only what others will pay for them. Regardless of whether the market will pay $10 or $75 for the said stock, we believe that the underlying business is creating value for its owners over time. **If a business is creating value, we want to own the shares of that company regardless of what is happening in the market day-to-day.**

A practical analogy for this is to think about your wardrobe. Imagine your favorite store is three weeks away from the annual sale on its summer collection. You know with certainty that prices will drop once the sale starts, but you are not sure which items, styles, and colors will be available at these lower prices. Would you go through your closet and sell all of your summer clothes in anticipation of replacing them at lower prices once the sale starts? No – that's ridiculous! Those clothes are still useful and it does not make sense to start from scratch. Plus, there will be many sale items that do not work for you – the style is unflattering, you do not like the color, or the item does not fit well. The sale, however, would be a great time to get a couple of new outfits to fill out your wardrobe at lower prices.

Another reason to stay invested in the face of volatility is that the decision to "get out" implicitly creates another decision point for investors in the future – "when do I get back in?" Just as System 1 distracts us when markets are declining, it also prevents us from acting rationally when markets are going up. System 1 will convince us to wait until the market "feels" safe. **In the interim, we miss out on the value created by the business we previously owned and are waiting to buy again.**

With all the noise spewed at us by market pundits each day, it can seem that the most important choice an investor needs to make is when to be in or out of the market. If one has a crystal ball with the ability to pick the market's exact bottoms and tops, timing the market is the best strategy. We, however, do not have this crystal ball, and nor do any of these pundits. Thus we view this strategy as a losing game for the individual investor. **With a sound financial plan anchored in the belief that stocks of high-quality businesses have intrinsic value, individual investors can weather the storm of volatile markets knowing that short-term market declines should have little to no impact on their ability to meet their long-term financial goals.**

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