PERSPECTIVES

JUNE 2016

Volatility: 10 key messages for investors

The UK's Brexit vote is a reminder that financial markets can be subject to periods of event-related volatility during which investor confidence can be significantly undermined. Here, we provide 10 key messages to help investors navigate their portfolios through volatile times.

10 THINGS TO REMEMBER WHEN VOLATILITY STRIKES:

- Volatility is a normal part of long-term investing
- Long-term investors are usually rewarded for taking equity risk
- Market corrections can create attractive opportunities
- Avoid stopping and starting investments
- The benefits of regular investing tend to stack up
- Diversification of investments helps to smooth returns
- A focus on income increases total returns
- Investing in quality stocks delivers in the long run
- Don't be swayed by sweeping sentiment
- Active investment can offer benefits in periods of increased volatility.

1. VOLATILITY IS A NORMAL PART OF LONG-TERM INVESTING

From time to time, there is inevitably volatility in stock markets as investors react nervously to changes in the economic, political and corporate environment. Above all else, financial markets dislike uncertainty. Yet, markets are also prone to over-react to events that cloud the short-term outlook. As an investor, it is important to take a step back at these times and keep an open mind-set. When we are prepared at the outset for episodes of volatility on the investing journey, we are less likely to be surprised when they happen, and more likely to react rationally. By having an open mind-set and a longer-term investment perspective that accepts short-term volatility, investors can begin to take a more dispassionate view. Not only does this help with the job of staying focused on long-term investment goals, it also allows investors to begin to exploit lower prices rather than lock in losses by emotionally selling at lower prices.

2. OVER THE LONG TERM, EQUITY RISK IS USUALLY REWARDED

Equity investors are typically rewarded for the extra risk they face – compared to, for example, sovereign bond investors – with higher average returns over the longer term. It is also important to remember that risk is not the same as volatility. Asset prices regularly fluctuate beyond than their intrinsic value as markets regularly overshoot or undershoot, so investors can expect price volatility to drive opportunity. In the long term, stock prices are driven by corporate earnings and have generally outperformed other types of investment in real terms, i.e. after inflation (see Charts 4, 5, 6 and 7).

3. MARKET CORRECTIONS CAN CREATE ATTRACTIVE OPPORTUNITIES

Corrections are a normal feature of stock markets; it is normal to see more than one over the course of a bull market. A stock market correction can be a good time to invest in equities as valuations become more attractive, giving investors the potential to generate above-average returns when the market rebounds. Some of the worst historical short-term stock market losses were followed by rebounds (see Chart 1).

4. AVOID STOPPING AND STARTING INVESTMENTS

Investors who remain invested typically benefit from the long-term uptrend in stock markets. When investors try to time the market and stop-and-start their investments, they can run the risk of denting future returns by missing the best recovery days in the market and the most attractive buying opportunities that become available during volatile times. Missing out on just five of the best performance days in the market can have a significant impact on longer-term returns (see Chart 2 and Table 2).

5. THE BENEFITS OF REGULAR INVESTING STACK UP

Irrespective of an investor's time horizon, it makes sense to regularly invest a certain amount of money in a fund, for example each month or quarter. This approach is known as cost averaging. While it doesn't promise a profit or protect against a market downturn, it does help investors to avoid investing at a single point in time, lowering the average cost of their fund purchases. And although regular saving during a falling market may seem counter-intuitive to investors looking to limit their losses, it is precisely at this time when some of the best investments can be made, because asset prices are lower and will benefit from any market rebound. (Investors should always review their portfolio from time to time and adjust it if needed.)

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6. DIVERSIFICATION OF INVESTMENTS HELPS TO SMOOTH RETURNS

Asset allocation can be difficult to perfect as market cycles can be short and subject to bouts of volatility. During volatile markets, leadership can rotate quickly from one sector or market to another. Investors can spread the risk associated with specific markets or sectors by investing into different investment buckets to reduce the likelihood of concentrated losses. For example, holding a mix of ‘risk’ assets (equities, real estate and credit) and defensive assets (government and investment grade bonds, and cash) in your portfolio can help to smooth returns over time.

Investing in actively managed multi-asset funds can be a useful alternative for some investors as they provide ready-made asset level and geographic portfolio diversification. These funds are typically constructed on the basis of strategic long-term asset returns, with asset weights managed tactically according to expected conditions. Spreading investments over different countries can also help to bring down correlations within a portfolio and reduce the impact of market-specific risk.

7. INVEST IN QUALITY, INCOME-PAYING STOCKS FOR REGULAR INCOME

Sustainable dividends paid by high-quality, cash-generative companies can be especially attractive, because the income element tends to be stable even during volatile market periods. High-quality, income-paying stocks tend to be leading global brands that can perform robustly throughout business cycles thanks to their established market share positions, strong pricing power and resilient earnings. These companies typically operate in multiple regions, smoothing out the effects of patchy regional performance. This through-cycle ability to offer attractive total returns makes them a useful component of any portfolio.

8. REINVEST INCOME TO INCREASE TOTAL RETURNS

Reinvesting dividends can provide a considerable boost to total returns over time, thanks to the power of compound interest (see Chart 3). To achieve an attractive total return, investors need to be disciplined and patient, with time in the market perhaps the most critical yet underestimated ingredient in the winning formula. Regular dividend payments also tend to support share price stability and dividend-paying stocks can compensate for the erosive effects of inflation.

9. DON’T BE SWAYED BY SWEEPING SENTIMENT

The popularity of investment themes ebb and flow – for instance, technology has come full circle after a late 90s boom and 2000s bust. Overall sentiment to emerging markets tends to wax and wane with the commodity cycle and as economic growth slows in key economies like China. As country and sector specific risks become more prominent, investors need to take a discriminating view, since a top-down approach to emerging markets is no longer appropriate. But there are still great opportunities for investors at the stock level, as innovative emerging companies can take advantage of supportive secular drivers like population growth and expanding middle class demand for healthcare, technology and consumer goods and services. The key point is not to allow the euphoria or undue pessimism of the market to cloud your judgement.

10. ACTIVE INVESTMENT CAN BE A VERY SUCCESSFUL STRATEGY

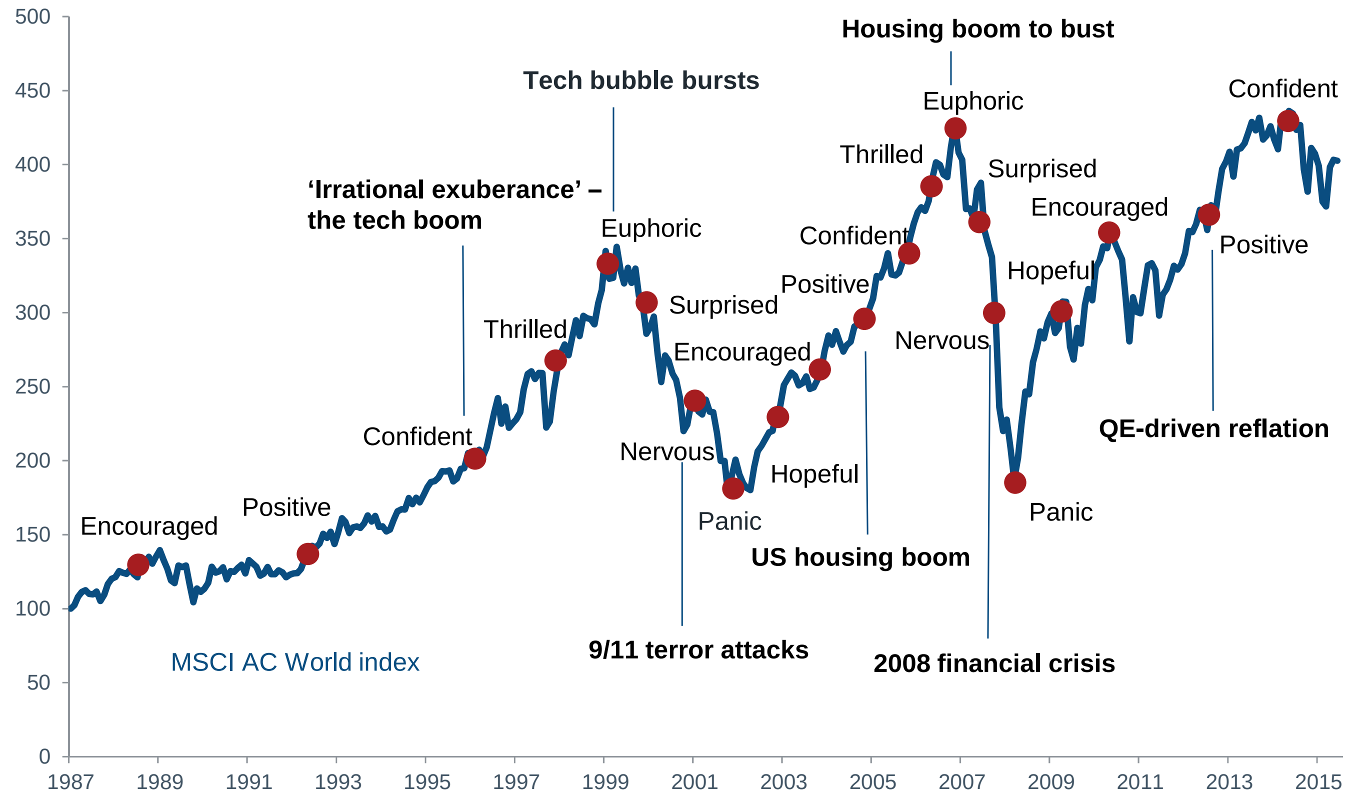
When volatility increases, the flexibility of active investing can be especially rewarding compared to the rigid allocations of passive investments. In particular, volatility can introduce opportunities for bottom-up stock-pickers, especially during times of market dislocation. At Fidelity, we believe strongly in active management and we have one of the largest buy-side research teams in the asset management industry to support this. Because we analyse companies from the bottom up, we are well positioned to invest when other investors might be shying away during bouts of market volatility. Remember, too, that the stocks you do not own in a fund can be as important as the ones you do. There are companies in every stock market that are poorly managed or which suffer from fundamentally difficult outlooks; these stocks can be completely and beneficially avoided in active strategies. Moreover, the value added by avoiding some of the worst stocks in the market builds over cycles and with the passage of time, making research-driven active strategies particularly appealing for long-term investors.

LOOKING THROUGH VOLATILITY

Historical data can provide useful context that helps investors to both look through volatility and take an unemotional, long-term approach to their investments.

These charts and tables provide compelling evidence for a long-term approach, showing, for example, why an approach of stopping and starting investments over time can run the risk of missing out on some of the best periods of returns.

Chart 1. How emotions can lead you astray



Source: Datastream, June 2016

Table 1. Strongest quarters generally outnumber the weakest ones

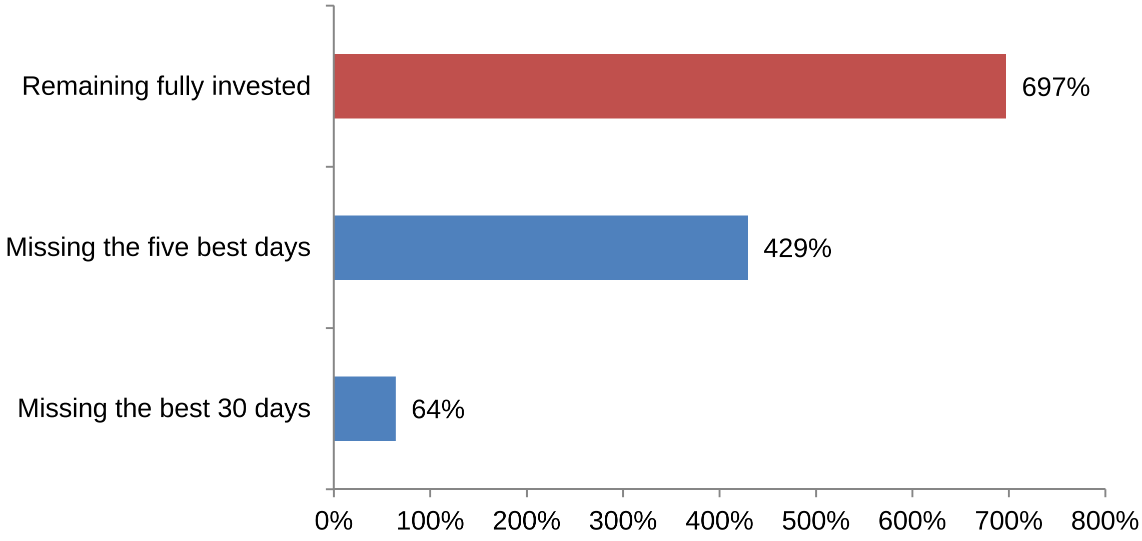
Q1 1992 to Q1 2016	Number of quarters with **gains** of 10% or greater	Number of quarters with **declines** of 10% or greater
CAC 40	16	11
DAX	24	11
FTSE 100	9	9
Hang Seng	22	12
Nikkei 225	16	21
S&P 500	15	8

Source: Datastream, June 2016. All calculations use local currency total returns, except for the Nikkei 225, for which the calculations are based on the price index.

TIME IN THE MARKET BEATS TIMING THE MARKET

Inertia can be a positive force once the decision to invest has been made: missing the best days in the market can have a significant impact on your overall investment return.

Chart 2. Total return and impact of missing the five and 30 best days in the S&P 500 (1992-2015), US$



Source: Datastream, Fidelity International, June 2016

Table 2. The impact of missing five or 30 of the best-performing days over the long term

01/01/1992 to 31/12/2015	Total return for the entire period	Total return minus **five best-performing days**	Total return minus **30 best-performing days**
CAC 40	452%	244%	-15%
DAX	581%	329%	2%
FTSE 100	486%	294%	28%
Hang Seng	1055%	495%	11%
Nikkei 225	-17%	-47%	-87%
S&P 500	697%	429%	64%

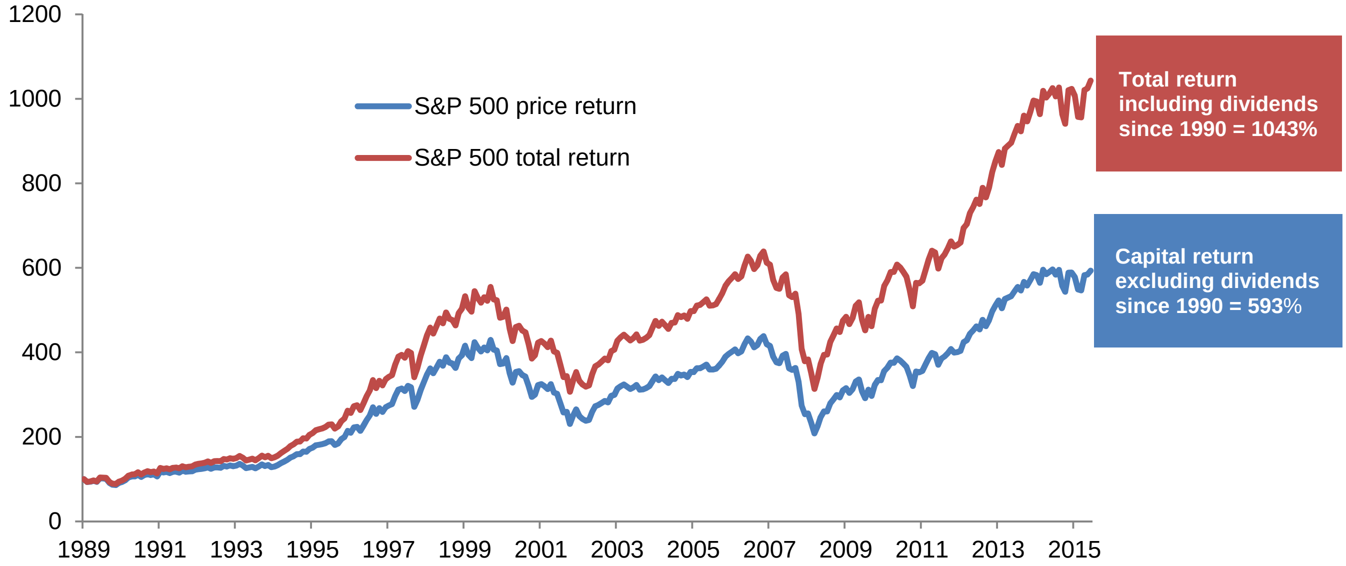
Source: Datastream, June 2016. All calculations use local currency total returns, except for the Nikkei 225, for which the calculations are based on the price index.

Table 3. The best three-year and five-year periods of return between 1988 and 2015

	Best return in a three-year period	Up to end of year	Best return in a five-year period	Up to end of year
CAC 40	175%	1999	261%	1999
DAX	141%	1999	230%	1999
FTSE 100	89%	1997	168%	1999
Hang Seng	293%	1993	342%	1993
Nikkei 225	106%	2014	86%	2015
S&P 500	126%	1997	251%	1999

Source: Datastream, June 2016. All calculations use local currency total returns, except for the Nikkei 225 and the Hang Seng, for which the calculations are based on the price index.

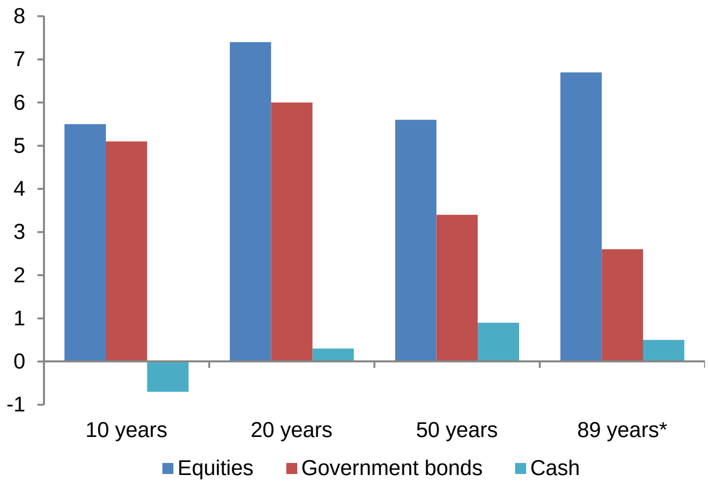
Chart 3. The power of dividend reinvesting



Source: Datastream, June 2016. Index rebased to 100 at end-1989.

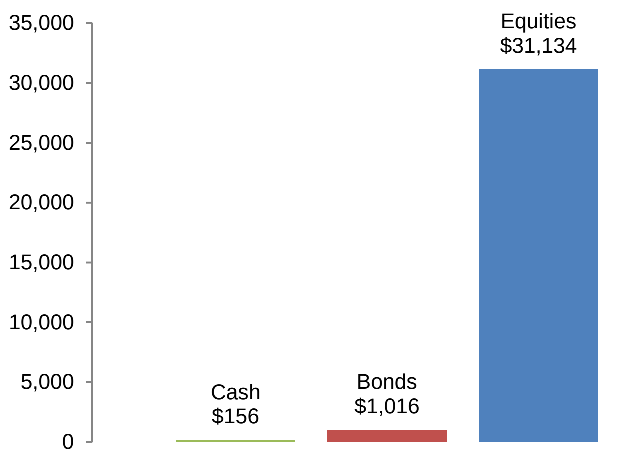
Over the long term, equity risk is rewarded:

Chart 4. Real US investment returns by asset class (%pa)



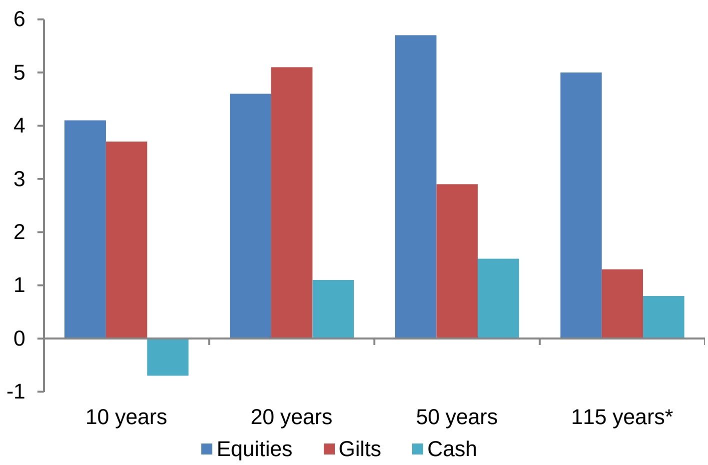
* Entire sample. Source: Barclays Equity Gilt Study 2015

Chart 5. Value of US$100 invested at end of 1925, as at the end of 2014, with gross income reinvested (in real terms)



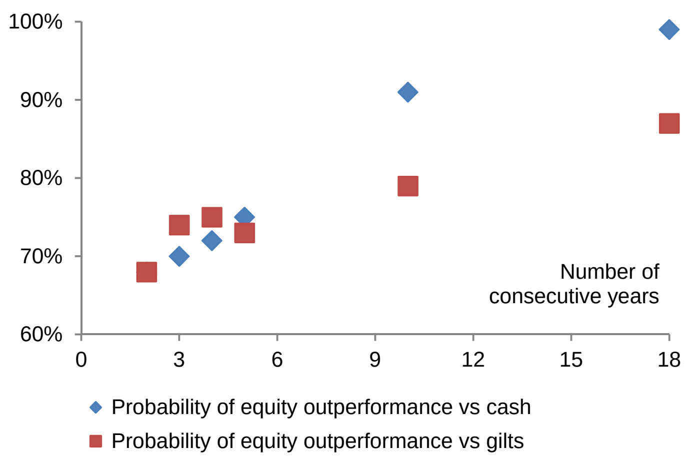
Source: Barclays Equity Gilt Study 2015

Chart 6. Real UK investment returns by asset class (%pa)



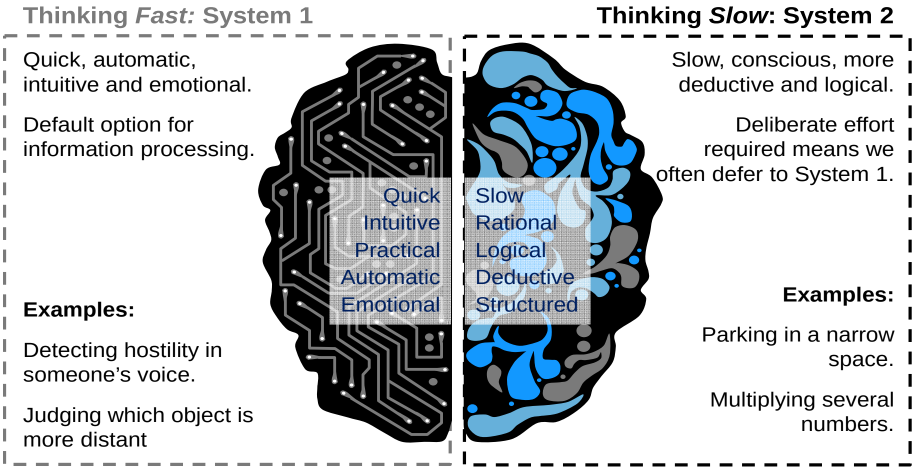
Source: Barclays Equity Gilt Study 2015

Chart 7. Historic UK equity performance, consecutive years



Source: Barclays Equity Gilt Study 2015

Chart 8. Why decisions are not always rational

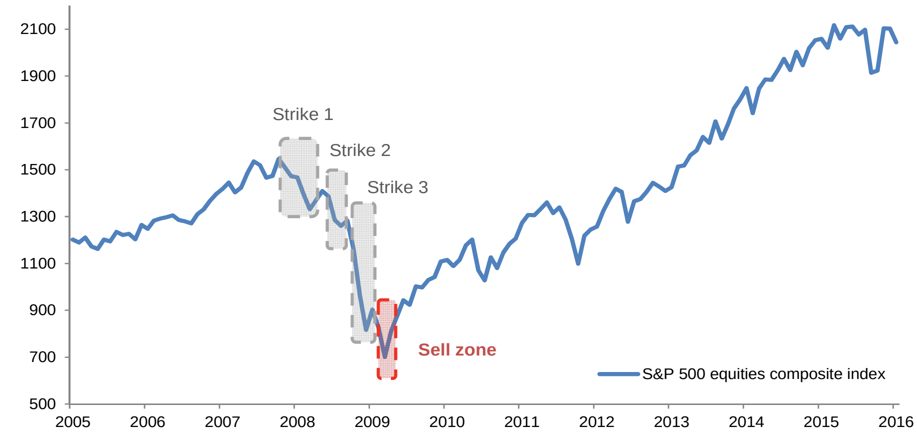


Source: Fidelity Worldwide Investment; Daniel Kahneman 'Thinking Fast and Slow'

Behavioural finance experiments have demonstrated that investors are far from rational in practice. In fact, when investors are confronted by complexity and uncertainty, tests consistently show that we revert to using rules of thumb or decision-making shortcuts. Research suggests our brains have two cognitive decision-making systems, fast-thinking System 1 and slow-thinking System 2. System 1 is automatic and often unconscious - the evolutionary older part of our brain that controls the fight or flight response and responds to the environment as quickly as possible, especially in times of danger. System 2 is the more recent part of our brain that is engaged for challenging problems where calculation and deliberation is required. Investors tend to revert to the automatic, emotionally influenced System 1 during times of stress and uncertainty, rather than use the deliberative and rational System 2.

We tend to revert to the automatic, emotionally influenced System 1 during times of stress and uncertainty, rather than have to deal with the larger cognitive processing load on our controlled and calculating System 2.

Chart 9. 'Three strikes and I'm out'



Source: Datastream, June 2016

Moreover, there are two principal behavioural biases that can kick in during times of market stress, causing investors to capitulate (System 1 deciding) and sell at the wrong time for the wrong reasons: herding and loss aversion. The urge to do as others are doing is a particularly powerful bias in human behaviour that has aided social development, but is not always helpful in investing. More seriously, following the herd means that investors end up buying when prices are high and selling when prices are low. This is known as 'chasing the market' - a terrible investment strategy. In reality, it is typically better to do the opposite, buying when others are fearful and prices are low, and selling when other are greedy and prices are high. The best investors know this but for many of us, going against the herd feels very difficult as we have to fight our emotions. The second bias, loss aversion, is one of the most significant behavioural biases that can affect investment. Experiments show that people take the safe option in gambles that involve gains, but take risk in gambles that involve losses, and that we feel the pain of a loss twice as deeply as the happiness from a gain.

One of the most serious investment implications of following the herd is that **investors end up buying when prices are high and selling when prices are low.**

In addition, **we avoid losses** as we feel the pain of a loss about twice as deeply as the happiness from a gain.

WHAT THE EXPERTS SAY

These quotes from some of the most successful investors illustrate how investing in stock markets can be a challenging yet rewarding venture, requiring strong research skills, a rational, dispassionate mind-set, a long-term horizon and patience in equal measure.

"The first rule of investment is 'buy low and sell high', but many people fear to buy low because of the fear of the stock dropping even lower. Then you may ask: 'When is the time to buy low?' The answer is: When there is maximum pessimism."

Sir John Templeton

"You pay a very high price for a cheery consensus. It won't be the economy that will do in investors; it will be the investors themselves. Uncertainty is actually the friend of the buyer of long-term values."

Warren Buffett

"Everyone has the brainpower to make money in stocks. Not everyone has the stomach. If you are susceptible to selling everything in a panic, you ought to avoid stocks and mutual funds altogether."

Peter Lynch

"When an investor focuses on short-term investments, he or she is observing the variability of the portfolio, not the returns – in short, being fooled by randomness."

Nassim Nicholas Taleb

"The stock market is the story of cycles and of the human behaviour that is responsible for overreactions in both directions."

Seth Klarman

"In the short run, the market is a voting machine, but in the long run it is a weighing machine."

Benjamin Graham

"Unless you can watch your stock holding decline by 50% without becoming panic-stricken, you should not be in the stock market."

Warren Buffett

"If investing is entertaining, if you're having fun, you're probably not making any money. Good investing is boring."

George Soros

"More money has been lost trying to anticipate and protect from corrections than actually in them."

Peter Lynch

"Bull markets are born on pessimism, grow on scepticism, mature on optimism and die of euphoria."

Sir John Templeton