

Many financial advisers claim it is possible to have high-return, low-risk strategies by trading actively in volatile markets. But, argues **Javier Estrada**, investors should settle in for the long term and hold their nerve even when the value of their shares is falling sharply.

No Gain Without Pain

✔ We all know that eating properly is essential for our health. Most of us are aware that certain types of food are good for us while others are best avoided. We are also aware of the trade-off between the desirable long-term goal of being fit and healthy and the pain associated with denying ourselves foods that we really like. We also know that patience and discipline are required.

What does healthy eating have

to do with investing, you may well ask? Arguably, there are plenty of similarities. Anyone who has gone into a bookstore in search of a book on healthy eating will have been confronted by rows and rows of books, each outlining a different miracle diet.

Anyone looking for a book on investing has a similar experience. Shelf after shelf bulges with books outlining “high-return, low-risk”

strategies. Each gives the impression that all we need do is to follow the indicated path to instant riches. If only life were as easy! If so, I would not be writing these lines and you would not be reading them – we would probably both be enjoying the Caribbean sun.

Most of us recognise that eating healthily is going to require a long-term commitment and the making of certain sacrifices (we must kiss goodbye to all those tasty 600-calorie blueberry muffins), and that there is no such thing as a painless shortcut. The same applies to investing.

In reality, the only way to generate high long-term investment returns is to endure some risks in the short term, with the associated pain that comes from sleepless nights as our portfolio value bounces about. There is no such thing as a “high-return, low-risk” strategy. Sadly, the same “no pain, no gain” rule applies both to eating and to investing.

And yet, when it comes to investing, many investors are seduced by “get rich quick” schemes. They often get blinded by the lights of easy money and delude themselves into thinking that gain can be achieved without pain.

Strategies on offer to investors can broadly be divided into two types: in one group are the “exciting” active investment strategies, which usually promise high returns but claim to achieve them with little or no risk; in the second group are the more boring and conservative passive strategies, which usually promise no gain without pain.

The approaches can be assessed from several standpoints, not all of which lead to the same conclusions. I will evaluate them here through the prism of my own recent research into

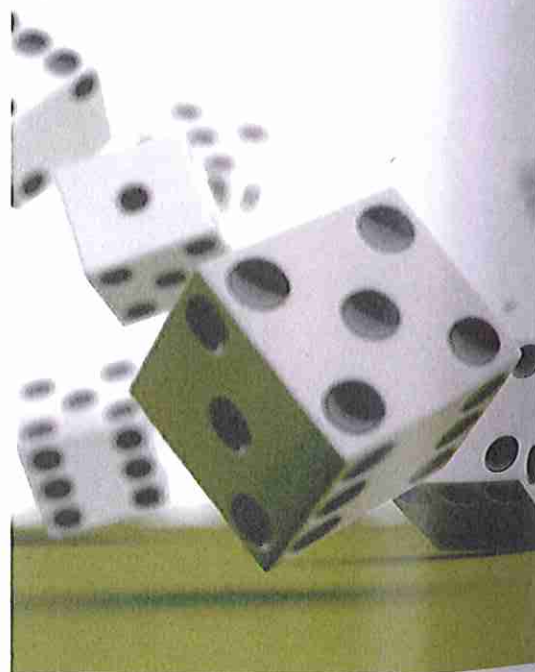
the so-called “black swans” in financial markets.

A black swan event is an outlier, in other words lying outside the realm of regular expectations because nothing in the past can convincingly point to its occurrence. It also carries an extreme impact and, despite being an outlier, plausible explanations for its occurrence can be found after the fact, thus giving it the appearance of being both explainable and predictable. In summary, a black swan is rare, has extreme impact, and is predictable in retrospect.

The black swan perspective of investing is based on three main ideas. The first is that an extremely small number of trading days have a disproportionate impact on long-term investment performance – this is an empirical fact. The second is that, although investing on the good days and not investing on the bad days would yield extraordinary returns, investors are extremely unlikely to get the timing right. And third, because attempts to time the market are doomed to fail in the long term (in fact, their main consequence is likely to be higher transaction costs), investors are better off holding a properly diversified investment portfolio for the long term.

Curiously, this is exactly the same recommendation put forward by advocates of the efficient market theory of investment. However, the black swan perspective assumes neither market efficiency nor normally distributed returns. Instead, it argues that return distributions have very fat tails and are therefore far from being normal. It also argues that mistakenly assuming that returns are normally distributed can lead to a massive destruction of wealth, as it leads investors to underestimate risk substantially.

Let’s first examine the facts. My own research reveals that a tiny number of days can have an exceptional impact on long-term portfolio performance. Across 15 developed markets, being out of the market on the ten days when the biggest stock market rallies occurred would have resulted in portfolios being 51 per cent less valuable than if the money had been passively invested. Not being invested in these markets



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There are two “sad truths” of financial markets. The first is that the higher the required return, the greater must be the exposure to risk and the second that the higher the exposure to risk, the longer must be the investment horizon. Deep inside, participants know that these statements are true, but a part of each of them would prefer to go on believing in painless shortcuts.

during their ten worst days would have resulted in portfolios being 150 per cent more valuable than a passive investment would have been.

Given that these ten days represent less than 0.1 per cent of the days in the average developed market I considered, the conclusion is obvious: a negligible proportion of days determines a massive creation or destruction of wealth, and the odds of successfully and consistently predicting the right days to be in and out of the market are nil.

In emerging markets, a tiny number of days have an even bigger impact on portfolio performance. My own research reveals that across 16 emerging markets, missing the ten best days would have resulted in portfolios being 69 per cent less valuable than if the money had been passively invested. Not being invested on the ten worst ten days would have resulted in portfolios being 337 per

cent more valuable than a passive investment would have been. Given that ten days represent 0.15 per cent of the days in the average emerging market I considered, the conclusion is again stark: the probability of successfully and consistently getting the timing right is negligible.

At times of high stock-market volatility such as during 2008, investors are often tempted to try and take advantage of large daily swings. In such turbulent times many investors attempt to capture outsize returns by frequently jumping in and out of the market, or from one market to another. But investors who engage in this sort of active trading, particularly in a volatile environment, are largely relying on luck rather than on a sound financial strategy.

Investors should bear in mind that the odds are heavily stacked against them; they should also remember that, while the additional transaction

costs of their active trading strategy are certain, outsize returns are, at best, a hope. A programme I run on portfolio management for individuals (as opposed to institutions) aims to give unsophisticated investors some basic tools with which to manage their savings.

The message for these investors is that there are two “sad truths” of financial markets. The first is that the higher the required return, the greater must be the exposure to risk and the second that the higher the exposure to risk, the longer must be the investment horizon. Deep inside, participants know that these statements are true, but a part of each of them would prefer to go on believing in painless shortcuts.

Investors should stop focusing on forecasting. There are many reasons why they should forget about trying to second-guess the market, which stock to buy or sell, or which currency

is going to appreciate. And there is an equally strong case for focusing on asset allocation instead. As with the “sad truths”, they instinctively know this advice to be right, but more often than not their response is to ask if the dollar is going to appreciate or the market is going to fall. Oh, well...

Some investors may well question the wisdom of being passively invested in the current environment as markets are displaying exceptional levels of volatility and apparently going nowhere but down. But hindsight is 20:20. It is very easy to say now that we should have cashed out at the beginning of 2008, but it did not look that obvious at the time. Trends, in fact, are not obvious until they are well in place. Black swans are unpredictable, and we only know when one has hit us after the event.

So, just as is the case with healthy eating, the long-term goal is desirable but the problem is “getting there”. Most investors know what they have to do along the way; most know that pain is a part of the process; most know that patience and discipline are essential; and yet most are tempted into shortcuts (“miracle diets” or “high-return, low-risk” strategies), even though they probably recognise that these may ultimately be dead ends. Whether it is healthy eating or investing, there is simply no gain without pain.

Black swans do exist, both in the natural world and in the financial markets. Those in nature are just a curiosity, but those in financial markets have critical implications for investor behaviour. Volatile markets invite investors to engage in a losing game. And yet, at the end of the day, black swans render market timing a “wild goose chase”. **Q**

