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Masterful inactivity

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In 1791 the Whig politician Sir James Mackintosh coined the phrase "a wise and masterful inactivity". This is how investors should respond to stock market fluctuations.

Almost all falls in the market are due to just two things: either the market is thought to have become riskier; and/or growth expectations fall.

Let's take the first case first. Share prices fall when risk increases simply because investors need a higher risk premium to compensate them for the greater risk - and this can only be obtained if shares fall to a level from which subsequent returns will be higher. For the average investor, this is a wash: the unpleasantness of higher risk is offset by higher expected returns. He should not, therefore, change his asset allocation. The same applies, in reverse, if shares rise because of a reduction in perceived risk.

We can think of this another way. In the late 60s Robert Merton at the Massachusetts Institute of Technology devised a simple rule for allocating wealth between a risky and safe asset. The share of wealth you invest in the risky asset, he said, should be equal to the expected return on the risky asset relative to the safe one, divided by the product of two things: the variance of the risky asset and a measure of your risk aversion.

This tells us that you should only change your asset allocation if one of three things changes: expected returns; variance; or risk appetite. A rise in variance is a reason to sell. But a rise in expected returns is a reason to buy. The two should cancel out. You should therefore do nothing.

But what if shares fall because growth expectations decline? This is very different from a rise in risk. If the market falls because of higher risk, expected returns increase. If, however, it falls because of lower growth expectations, expected returns just stay low.

However, even this is not necessarily a reason to change asset allocation, for two reasons.

First, it is almost impossible to distinguish between a fall in the market because of lower growth expectations and one because of increased risk - though it's easier to do so for

individual stocks.

Secondly, it's very possible - to say the least - that the market over-reacts to bad news about future growth. If so, such news can cause shares to become genuinely cheap. If you'd sold in mid-October or mid-December when the FTSE 100 fell to 6200, you'd have missed the big bouncebacks.

Of course, it's hard to distinguish between the market being under-priced and it being cheap for a good reason; everyone has an opinion, but opinion is not fact. And this is a case for doing nothing in response to market falls. We must weigh the possibility that growth prospects have genuinely worsened against the possibility that the market has over-reacted so that shares are genuinely cheap. One's a reason to sell, the other's a reason to buy and the two might well net out. The same applies, mutatis mutandis, if the market rises.

"Keep calm and carry on" has become an over-used cliché. But it's a good description of how we should respond to stock market moves.

This raises the question: should we ever change our asset allocation?

One reason to do so is that the "sell in May, buy on Halloween" rule has proved successful around the world. However, this only works for investors who are prepared to act against our natural seasonal fluctuations in risk aversion. Shares are high in the spring precisely because that is when we want to take risk and they are low in the autumn because that's when we are nervous. Selling in May and buying in October therefore means selling when we don't want to and buying when we are worried. This is difficult to do - which is why the rule continues to work.

Another possibility is simply that our personal circumstances change. Not all of these, however, justify changing asset allocation.

For example, financial advisors sometimes tell us to shift into safer assets as we get older. But there are reasons not to do this. Javier Estrada at IESE Business School in Barcelona says that having more equities when you are young and fewer when you are old is "suboptimal in terms of capital accumulation". This is simply because a 20 per cent rise in the market makes you only £2000 if you have £10,000 invested but £20,000 if you have £100,000 – so avoiding equities when we are older and richer means missing some big gains as well as big losses. And Ravi Jagannathan at Northwestern University has shown that if your wages and job prospects are correlated with the stock market, shares become safer as you get older.

All this warns us that changing asset allocation can be unwise. Once you've got a portfolio you feel comfortable with, there's a good case for sticking with it through thick and thin. Masterly inactivity might not maximise your wealth - which is impossible anyway in an unpredictable world. But it'll save you from the expensive error of buying high and selling low. In this sense, there's much to be said for it.

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