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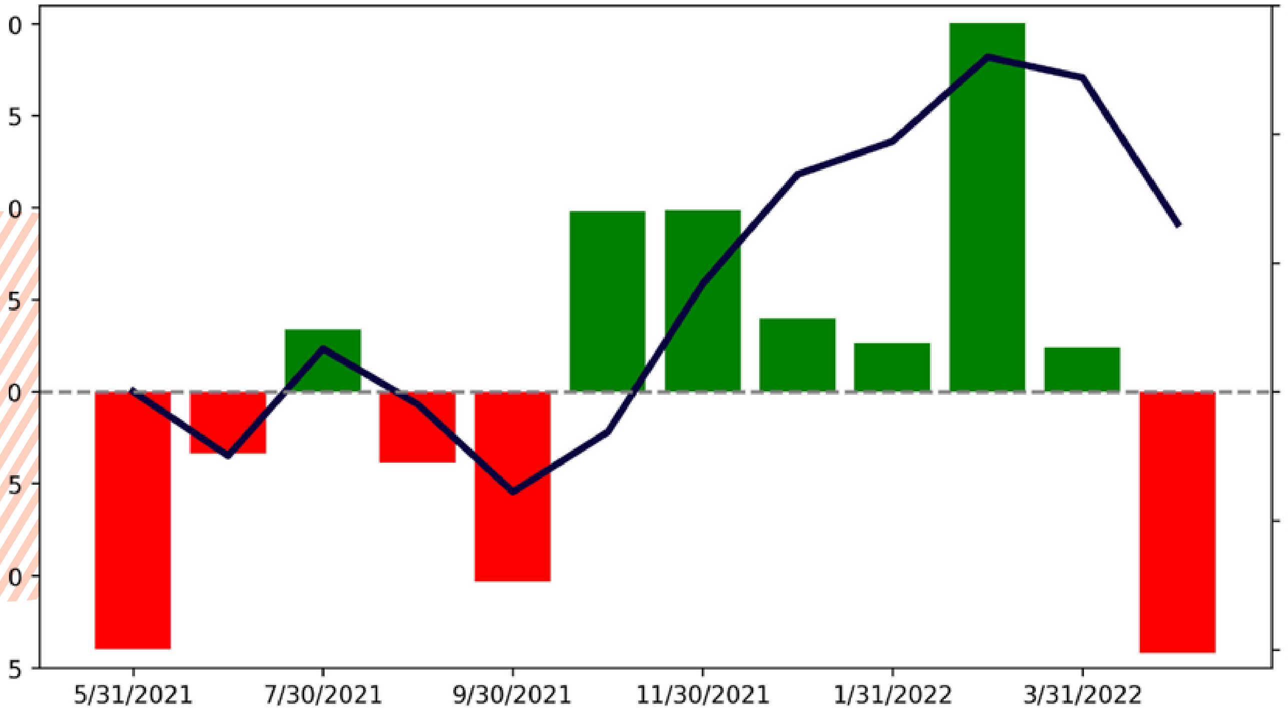
Buying High and Selling Low

by Garrett Nel

Due to the economic uncertainty throughout 2022, the FTSE/JSE All Share Index has hit a slump along with global equity markets. The cause of the downturn is as always multifactorial; markets are strained by the effects of the Ukraine war, Chinese lockdowns and increasing regulatory burdens on their economy, and inflation and interest rate fears.

In response to negative market movements, investors often react emotionally by withdrawing their money from the market out of fear of losses. Similarly, when markets are doing well, investors tend to invest more money into the market for fear of missing out on returns. Although these mostly rational investors are likely aware of the dangers of market timing, this strategy is seen as being defensive rather than trying to beat the market. Unfortunately, in an effort to minimise losses while maximising gains, investors more often than not erode returns when compared to just staying in the market.

The figure below presents the price level of the South African equity market over the year up until the end of April, as well as the trade volumes of two of the largest ETFs tracking the index. Instead of buying low and selling high, the fear of market movements causes market participants to do the very opposite. In addition to transaction fees, most active investors who traded in this period experienced a loss or poor gains on their investment due to their trades, compared to the 6.5% return they would have experienced by simply holding their position. This is just one example of many repeated instances of this behaviour.



Source: S&P Capital IQ Pro

It is important to note that, even through the current drawdown, the annualised total return of the ALSI over the last 3 years is 11.26% per year. This period includes the correction markets experienced during Covid-19. Markets tend to overreact—the Covid crisis saw a drawdown of 34% in the Index in less than four months; however the following year it experienced a return of 74% from the lowest point in the dip. As such, markets tend to oscillate around their "true" value and will revert back to rational levels once fear and greed has subsided.

The same investor irrationality appears in the flows of multi-asset funds. In this case, market participants are effectively taking the risk management of their portfolios into their own hands, even though they are paying fees to professional investors who are already responsible for risk management.

Unfortunately, not all fund managers place the same emphasis on risk management. The phrase "we are not concerned about volatility" is uttered frequently as though it has no effect on the outcome of real clients' portfolios. While it may be the case that some strategies are grounded on good fundamentals that are more likely to produce good returns, not all investors would reap the benefits of the strategy as they move their capital to the wrong place at the wrong time. For this reason, choosing the right fund for one's investment philosophy is crucially important, as the temptation of protecting one's portfolio from uncomfortable losses is natural.

Source: S&P Capital IQ Pro

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