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Investment insight
February 2025

Living with volatility

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Field Marshall Helmuth von Moltke the Elder was the Prussian Army's chief of staff for 30 years during the late 19th century. He is arguably best known for conceiving the idea that no strategy survives first contact with the enemy.

Of course, the chances are that you have never heard of him. He is really familiar only to those of us who regard ourselves as students of military history. But fear not: his thinking lives on today in the wisdom of Mike Tyson.

It was the former heavyweight boxing champion who famously remarked: "Everyone has a plan until they get punched in the mouth." This may well be the most concise encapsulation of von Moltke's concept ever articulated.

So what does this determinedly blunt axiom have to do with investing? The short answer is that we are living in volatile times[1] – and volatility can sow doubt in investors' minds.

In my view, it is essential to recognise this doubt can often be unwarranted. To understand why this is the case, we first need to reflect on how volatility has established itself as a "new normal".

The ripple effects of short-term thinking

We all know geopolitical and geoeconomic uncertainty can trigger sharp fluctuations in the prices of assets. So can controversial policy decisions, upheaval on a national or more localised level, cross-border conflicts, pandemics and the like.

Much less appreciated is that a regular source of volatility today lies in the wonderful world of investment analysis. This sphere – commonly referred to as the "sell side" of our industry – is mainly comprised of fund brokers, major investment banks and so-called "independent" research houses.

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One of the investment analysis community's key tasks is to make sense of the raft of financial information disclosed by businesses. The resulting insights can then be used to guide decisions on whether to buy, hold or sell specific stocks.

This form of analysis once had a relatively long-term focus, but in recent years many forecasts have become much more short-term in nature – perhaps extending no further than a few months. This is in no small part due to the rise of hedge funds and high-frequency trading, as well as a desire among market managers and regulators for quarterly reports.

Problems can occur if an analysis turns out to be overly positive, as market participants may interpret a company's unforeseen underperformance as a sign of permanent underperformance. This leads to volatility – which, in turn, can spark turmoil. Even a weaker/stronger-than-expected company statement can leave stocks bouncing like an opponent careening off the ropes during Iron Mike's heyday.

The merits of holding firm

This brings us back to von Moltke's philosophy and Tyson's typically punchy aphorism. As investors, we might believe we have a plan – but then volatility comes along and smacks us in the mouth.

How should we react? In my opinion, a good way of framing the necessary response is to retain a clear notion of what we hope to accomplish but at the same time be prepared to be flexible.

In other words, above all, we should not panic. We should not rush to sell everything we possess or radically reshape our portfolios. The reality is that in most instances, at least over the long term, doing very little is likely to be a prudent approach.

This may fly in the face of our instincts. A phenomenon known as "action bias" means humans are inherently inclined to favour doing something over doing nothing – which is why, for example, goalkeepers seldom stand still when facing a penalty.

Yet history shows leaping in and out of markets is rarely a productive course of action, as it risks missing out on a recovery. To quote another useful maxim: "Time in the markets beats timing the markets."

Reassessment, not revolution

We ought to acknowledge at this point that near-relentless change might make sense for some investors. The aforementioned hedge funds and high-frequency traders can revel in such a frenzy, because their horizons are resolutely short-term – measured in weeks, days or even less – and are often fuelled by the use of leverage.

However, a blend of agility and patience is more appropriate for those of us who prefer a long-term outlook. When we get clobbered in the chops – figuratively speaking, that is – any action we may take should be suitably measured.

As von Moltke highlighted, there is always merit in reassessing and refining a plan. But simply tearing it up and tossing it away at the first sign of trouble is likely to prove less than pragmatic.

The fact is that portfolios can require a modicum of readjustment in any event. Asset allocations are constantly under consideration, because an investment garden must be tended if it is not to get overrun. That is a fundamental element of an investment manager's job.

Ultimately, volatility is just one of many reasons for us to give thought to our holdings. It can even be an ally in some instances, providing us with a better entry or exit point. Barring truly exceptional circumstances, it should not be mistaken for some sort of full-blown crisis – and it should certainly not be deemed grounds for abandoning a successful investment process.

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1. Investors keen to dig deeper into this issue may be interested in the VIX, a widely used measure of the stock market's expectation of volatility. There are several theories as to why the VIX has generally remained subdued in recent years, including the changing nature of market hedging and the possibility that it might simply be "broken". Another discussion for another time, perhaps.

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