Point of view

Mark Dutton, Chief Investment Officer – Australia & NZ, AXA

‘Breaking news’ – a risky basis for investment decisions

As financial markets face yet another round of turmoil and negative news, AXA’s Chief Investment Officer, Mark Dutton, looks at the risks of reacting to short-term news, and at strategies to deal with the volatility.

Our challenge – we were born to run

Events that rock investment markets make it hard for us to step back and see the full picture in context. Relying on the daily newsflow isn’t the answer. It’s hard to avoid the short-term pressures, but the ability to remain disciplined is essential for success.

The current period of market turmoil drives news that suggests urgency or imminent danger. At present, this may be true, but we can make matters worse with the wrong decisions. The human brain is hardwired with a ‘flight to safety’ response when faced with danger, which can trigger destructive reactions for investment decision making.

In the times of our early ancestors, survival was the daily challenge. The survival instinct needed to click in even before a rational thought process had time to work through the problem.

The hardwiring of our brains hasn’t really evolved much since this time. If a lion were to lunge at us, we would instantly jump back – even if the lion is behind steel bars at the zoo. In effect, we were born to run.

Running from investment risk can mean systematic failure.

Our natural reaction to threatening news on the investment front is similar. When danger appears, our initial response is an urge to run to safety.

These reactions can lead us to become risk adverse when opportunities abound, such as at the bottom of the market when everything seems extremely dangerous. The same reactions can also lead us to become risk seeking at the worst possible time, such as at the peak of a market when everything seems calm.

The ‘news’ may make things worse

‘News’ is not the same thing as ‘analysis’. It’s just news. For an event to be ‘newsworthy’ it needs to meet criteria such as urgency, emotion, conflict, proximity and significance.

These criteria are about triggering an emotional reaction. But this is a poor basis for making sound investment decisions. In fact, as shown by table 1 below, the most newsworthy stories are designed to meet criteria that can also drive poor investment decision making.

An additional problem is that the news needs to focus on the very latest developments. Investors need to be able to see the whole story in context. The focus inevitably shifts to the short term, especially when the short term seems bad.

The emotional content of the news is often drawn out in the headlines. Consider some of the headlines that were used to describe market falls in recent days and weeks – ‘The GFC is back and it’s here to stay’, ‘Armageddon’, ‘Markets tumble as investors fear GFC II’, ‘Bell rings for crisis, round 2’, ‘Turmoil wipes out share recovery’, ‘Time to take cover’, ‘What the meltdown means for you’.

There was some good economic and financial news through this period, but it didn’t appear on the front page.

Unless an investor can step back from this noise they are at risk of making an emotional decision.

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Table 1: The criteria to be newsworthy leads to poor investment decisions

Criteria to be newsworthy	*Poor investment decisions*
• *Urgency – new and immediate*	• *Too much emphasis on latest events*
• *Emotion – drama*	• *Acting on emotion*
• *Conflict – disagreement*	• *Distorted information*
• *Proximity – close to home*	• *Anchoring to selective information*
• *Significance – impact on people*	• *Following the 'herd'*

Seeing things differently

Graphics used in presenting a story can set the tone, but perspective makes a big difference. Contrast figure 1 with figure 2. They are both showing the same markets and include the impact of recent market falls, but with different scales and time frames.

Figure 1 makes the 15 per cent fall that occurred in late August seem like it was more severe than it was. As the headlines suggest, it really looked like the markets were falling 'over the cliff'.

Figure 2 highlights a different perspective. It reveals that the global sharemarket is still up by just over 60 per cent since March 2009 lows, even taking the recent 15 per cent fall into account.

This is hardly the case of heightened market volatility wiping out the sharemarket recovery as the headlines implied.

Figure 1:
Global sharemarket from Aug 10 to Aug 11

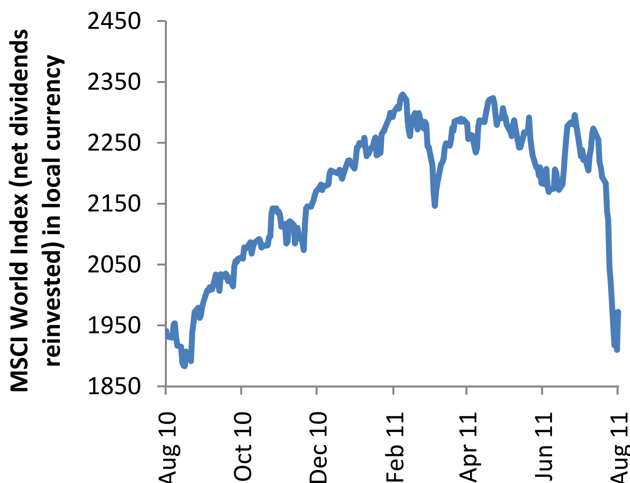
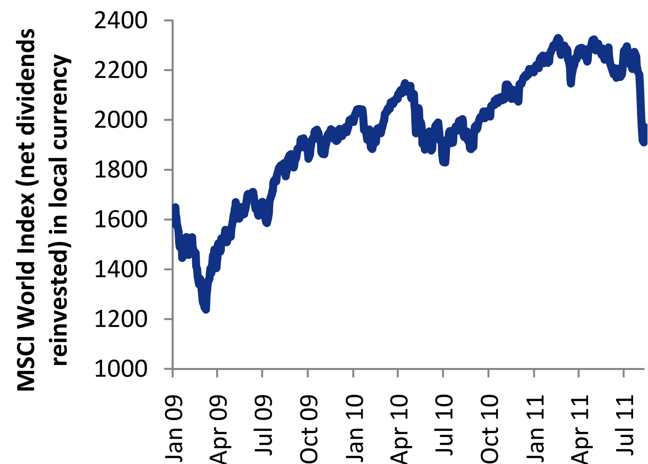


Figure 2:
Global sharemarket from 1 Jan 09 to Aug 11



Source: Datastream. Data up to 11 August 2011

Investing when anxious

A danger for investors is that if decisions are made on the basis of fear and panic, they are heightening the risk of simply following the 'herd' and creating a permanent capital loss.

A number of things can be done to reduce this risk.

Firstly, investors need a plan. This is not as obvious as it sounds. In good times, it is possible to achieve investment objectives in many ways, and even get away without much of a plan. In tough times, a plan can help ensure that investors don't become 'forced sellers' of assets during market downturns, by allowing for short term needs with appropriate assets. A plan can also provide peace of mind, which reduces the urge to sell when anxious.

Having a plan doesn't necessarily mean no change. But a plan allows for any adjustments due to personal or market conditions to be made on a sound basis. In tough times, having the right level of cash, diversification and financial protection are all decisions that are best evaluated in the context of a plan.

Secondly, be emotionally ready for bad news – markets are likely to have already priced this in. Most stock markets are already trading well below their normal long-term values, building a weak outlook into their prices. There can still be a short-term overreaction, but typically markets that are cheap eventually recover well.

In recent days, the increased potential for the Greek government to default on its bonds has spooked the market. That risk has been known for some time, and is reflected in the current interest rate of nearly 100 per cent on some one-year Greek government debt.

Thirdly, don't ignore positive developments. Sharemarket investors are invested in companies, not countries. Despite all of the volatility of recent months, many company profits are growing strongly. Compared with forecast profits, nearly 60 per cent of the western companies that make up the global sharemarket (as defined by MSCI) recently beat second quarter expectations. Company balance sheets are strong and in many cases, awash with cash.

Finally, turn off the news. Perhaps not literally, but tuning out to the day to day cut and thrust of the market movements improves the prospects for sound investment strategies to stay on track. In particular, it is important to be alert to the risk that newsflow could lead to poor investment decisions.

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