

Putting Your Market Emotions in Perspective

“I’ve made a killing...wait, I’ve lost money...wait, maybe not...”

In the financial industry, standard deviation is a metric commonly used as an indication of risk. It measures the variability of returns. Standard deviation is equated to risk because experience has shown that, in general, those securities that exhibit high variability of returns have a greater probability of losing money. Unless an individual has a strong mathematical background, it can be difficult for them to *intuitively* grasp the meaning of this metric. However, we currently have a great opportunity to illustrate the concept by looking at recent stock market action in the Dow Jones.

- Within half an hour of the close on July 31st the Dow dropped over 200 points to move from a net positive position to close down 146 points;
- From 12:00 noon on Tuesday July 24th through 3:30 PM on Wednesday August 1st the Dow dropped 796 points;
- It then rallied 358 points in the next 6 trading hours; and,
- This past Friday the market fell 280 points in the last 2 hours of the day and then Monday rose 305 points
- Every day ended with essentially a triple digit loss or a triple digit gain.

The joy and pain that many felt during that period was in fact the emotional response to high standard deviation and absolute returns (“I’ve made a killing”, or “I’ve lost money”). Another emotional response will usually follow the realization that one’s portfolio has underperformed the market (“I could have just bought the iSHARE!!”). Performance differential relative to an index is called tracking error. It can also be high.

Independence clients have experienced high tracking error, not high standard deviations of returns. Our returns have been stable throughout the year, in the low single digits, with the TSX moving around us. First the market went up and now it’s coming back down (we think there is more downside risk over the coming months). We have always said that we have high tracking error. As an active investment manager focused on a subset of the TSX, our returns are usually quite different from the index. Our style has not changed, but market trends have.

Interestingly enough, if Independence clients did not have BNN, CNBC, Bloomberg TV or a quote machine and only looked at the monthly portfolio value of an Independence portfolio they would not have experienced the anxiety due to the market’s volatility. Rather, they would have been somewhat bored. We take a long term, defensive and low risk approach in managing our portfolios. In addition, our returns are basically uncorrelated with that of other managers and they exhibit high positive tracking error over the long run. That’s why we think Independence portfolios belong in your client’s multi-manager structure.

