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When making investment decisions, beware the butterfly

In the old days economists thought that only major factors like nuclear bombs, bombastic politicians and plummeting oil prices had the power to influence economies. We now know that change can be brought about many minor incidents…even something so tiny as the flap of a butterfly's wing.

Read on to find out how the seemingly inconsequential butterfly should inform your investment philosophy, the makeup of your portfolio and even your daily spending habits.

What's in a name?

The "butterfly effect" is the simple concept that small things can have a significant impact within a connected system. The term was coined by Edward Lorenz, an American mathematician and meteorologist who argued that a tornado in the West could be initiated by a minor disturbance, such as the gentle flap of a butterfly's wing in the East, several weeks earlier.

Although Lorenz came up with the name, the concept has been around for ages. The little poem below is often attributed to the American statesman Benjamin Franklin, but it first appeared in a slightly different form in Germany as early as the thirteenth century.

For want of a nail, the shoe was lost,
For want of a shoe, the horse was lost,
For want of a horse, the rider was lost,
For want of a rider, the battle was lost,
For want of a battle, the kingdom was lost,
And all for the want of a horseshoe nail.

The butterfly effect and investing

This concept is extremely relevant to investing, as globalization and market interconnectivity continue to increase exponentially on the back of improved IT and internet access. In our connected world, instability and market volatility in one corner of the world can rapidly sweep across the globe.

Examples of the butterfly effect

In the world of finance, Black Monday refers to 19 October 1987 when stock markets around the world crashed. The crash was triggered in Hong Kong, spread to Europe and then hit the US, resulting in the Dow Jones Industrial Average losing 22% of its value in a single day. Even though investors were nervous about a stock market bubble given the 44% rise in the Dow over the previous 12 months, economists could find no real external cause for the plunge - it was retrospectively suggested that the crash could have been the result of fundamental errors in trading software which prompted snowballing sales as the markets declined.

In a more recent example, the Chinese Stock market experienced significant volatility in 2015, dropping more than 8% in one day. Within hours the selling spread to other markets, and the S&P 500 and the Nikkei both lost around 4%. Again, there appeared to be no real fundamental reason for the plunge. The Chinese government had been encouraging people to invest in the stock market, and at that point over 85% of investors were personal investors who knew little about investing and were trading on borrowed funds. After a small drop in share prices, panic selling spread in China and then reverberated throughout the world.

What can this teach us about investing?
Understanding the butterfly effect gives us the freedom to accept that we cannot predict what's going to happen with any level of certainty. This means that we need to include a degree of defensiveness in our portfolios to minimise the risk of capital loss at any point in time. This may involve: rebalancing your unit trust portfolio to maintain your original intended asset allocation; including bonds and cash in your portfolio; diversifying across sectors and regions, and, when market downturns occur, having confidence in your fund manager to manage your portfolio risk appropriately. They will have done the hard work in positioning your funds to best weather the storm.

The butterfly effect and you
The butterfly effect also applies on a personal level as your seemingly insignificant everyday spending and investing behaviors can have a big impact on your long-term financial stability. This has been much-discussed as the "latte factor", which is the simple idea that trivial daily expenditures can add up to a massive loss of capital in the long-run. To make matters worse, the effect isn't just the sum of the cost of all those coffees, it's also the loss of potential compound growth on the daily amounts spent.

To sum up
The concept of the butterfly effect should remind you to be cautious and take the appropriate risk in your financial decision making. You may think that you're invincible and you know it all, but you have to accept that you have no control over what happens in global financial markets. It is best to leave it to the experts to identify the risks on the horizon and let them limit the impact of market downturns on your portfolio.

While you certainly don't have to squirrel away every spare cent and live the frugal life of a hermit, it does make a lot of sense to be aware of the real cost of thousands of little expenses added together.

To find out more about Prudential funds contact our Client Services Team on 0860 105 775 or at query@prudential.co.za