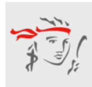

Prudential Investment Managers
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Beware of selling when markets are down

With local equities coming off the back of one of its worst years since the Global Financial Crisis, you may well be tempted to switch out of your equity investments and into assets that have experienced better relative returns (such as cash and bonds). While this may seem like a good idea, it's important to understand the impact that short-term actions could have on your long-term investment returns. In this article, we consider the potential consequences of switching when markets are down.

A loss is only a loss when you lock it in

Let's start by looking at a practical example to explain the concept of locking in your losses.

John invests R100 in equities. The stock market has a terrible year and John's investment drops by 10%. At this point his investment is only worth R90, however *he hasn't actually lost any money* as the value has only decreased on paper (also referred to as a paper loss). The next year the market rebounds and John's investment is now worth R110. Again, John hasn't actually made any money as the value has only increased on paper (also referred to as a paper profit).

John’s investment journey demonstrates three very important points:

1. If he sold his investment when the market was down he would have locked in (or realised) an actual loss of R10.
2. Selling at the wrong time would have resulted in him missing out on the opportunity for subsequent gains when the market recovered.
3. John was better off simply doing nothing and allowing the market to run its course.

Logic doesn’t always prevail

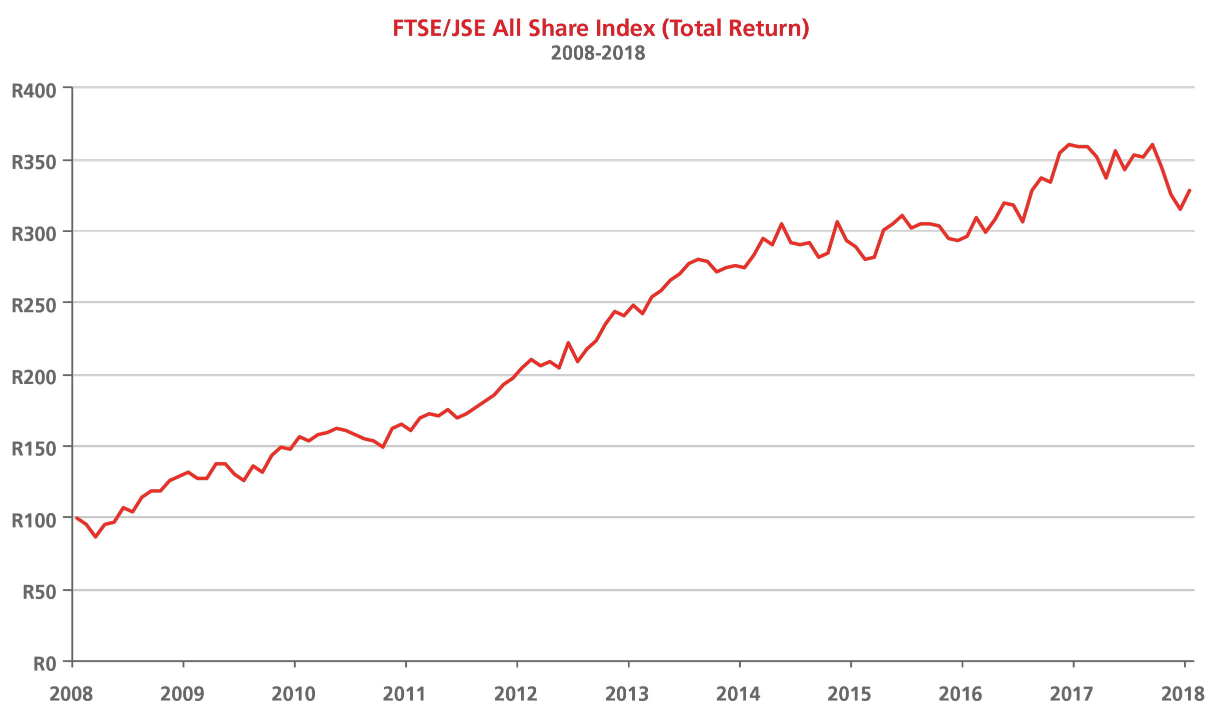
One of the basic principles of investing is to buy low and sell high. While this certainly is logical, it’s often the case that, as human beings, investors do exactly the opposite when markets underperform, selling their investments out of fear of further declines in value. This is especially true at times when returns have been disappointing for a long time, as is the case now in South Africa. What’s more, when markets recover and are on a roll, people tend to buy assets as a result of a “fear of missing out” or, more simply, greed. Then they end up investing after the price has been pushed up higher than the asset is worth. Essentially, they sell low and buy high.

"The stock market is a device for transferring money from the impatient to the patient”

If we were to apply this irrational behaviour to our example, John would have sold his investment at the bottom for R90 (thereby losing R10) and bought back into the market for R110 (which is R20 more than what he sold out for). The combination of selling low and buying high would have placed John R20 out of pocket, which works out to 20% of his initial R100 investment.

The trick is to be patient and not act out of emotion

The graph below shows what R100 invested on the FTSE/JSE All Share Index would be worth today. As you can see, there were many times when the market was down and the temptation to sell would have been strong. However, what the graph also indicates is that the long-term trend is clearly upward, suggesting that by simply having done nothing and staying the course, your investment would have continued to grow. The lesson here is to be patient, remove emotion from your investment decisions and remain invested when markets are volatile.



Source: IRESS

In conclusion, Warren Buffet said it best with the words: “the stock market is a device for transferring money from the impatient to the patient”… and we couldn’t agree more.

To find out more, speak to your financial adviser or contact our Client Services Team on **0860 105 775** or at query@prudential.co.za.