Heat of the moment

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In a previous edition of this magazine , we wrote about the fact that starting valuations do not matter so much if the holding period of our investment is large enough. The experience of the last 30 years of so in the equity markets suggest that an investor will get positive returns in equities as long as the holding period is of 10 years or more.

We know all this and the fact that returns are certainly good in the long runoff 10 years or more has been talked about in various forums by several eminent experts. If this is the case, then it begs the question, why is it that we have recommended caution to my investors? Why have we recommended investing in Equity Savings Funds (funds which have only 40% invested in equities) or Dynamic Asset Allocation Funds (where the equity % in the scheme varies from a low of 30% to as high as 80% at the fund managers discretion or based on a valuation formula) when we know that most of our investors are interested in holding on for 10 years or more. Why not invest in pure Equity Schemes like Multi Cap Funds or Midcap Funds and ride out the intermediate volatility. After all, typically, the multicap funds or mid-cap funds have given higher returns in the last 10 years when compared to the Equity Saving Funds.

The answer lies in this famous Mike Tyson quote “Everyone has a plan until they get punched in the mouth” This is a great insight. The best laid plans can fall to the wayside when faced with the harsh reality of the present. Every investor starts out with a plan to invest for the long term. But a sudden bout of volatility can lead to the investor discarding his plans at the worst possible moment.

Several studies have shown that Heat of the Moment is a real problem in human behavior. Almost everyone overestimates their ability to withstand temptation in the cool environs of the present. But the actual ability to withstand the temptation in the Heat of the Moment is lesser than we predict. For the investor, the lesson from these studies is that we overestimate our ability to hold on to investments during testing times.

We overestimate our own ability to remain unaffected by the market movement and the general mood around us. The real problem is that even knowing that we are susceptible to this fallacy of the Heat of the Moment doesn’t really help us. Being aware of this weakness does not help us to guard against it. All we can do as investors is to ensure that we take steps now that will ensure that we will not have to face such moments where decisions have to be taken in the Heat of the Moment.

This is where our recommendation of Equity Savings Fund or Dynamic Asset Allocation Funds come in. With current PE at more than 25 and with a fear of increasing interest rates, there is a very good chance that the next6 to 12 months will see volatility in the markets. While we can all believe that we are long term investors and can ride out this volatility, the fact is that staying with the plan when the market is punching you in the mouth is not necessarily going to be easy.

Investing in Equity Savings Funds or Dynamic Asset Allocation Funds at current valuations ensures that the volatility in our investment is much lower than the volatility in the market. This investment in Equity Savings Funds or Dynamic Asset Allocation Funds will therefore not cause us as much trouble as a normal equity investment in a falling market. This will perhaps reduce the tendency to react in the Heat of the Moment and thus increase the chance of holding on through the potentially volatile period.

When the valuations are lower and earnings visibility is higher, we can move our investments into more volatile equity products like Multi-Cap or Midcap Funds.