Of Rivers, Market Volatility and Whipsaws

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- Investors may have been tempted to react to recent market volatility by actively trading their portfolios, jumping in and out of the market in response to the latest developments.
- But markets rarely move in a straight line; big drawdowns are often followed by big reversals (and vice versa).
- That can create damaging "whipsaws" that destroy returns and create unnecessary anxiety.
- Below, we illustrate how mechanical trading models would have underperformed a simple buy-and-hold.

Have you ever wondered why rivers don't run in a straight line?

After all, the concept behind rivers is pretty simple: snow falls in the mountains, melts, then makes its way downhill from Point A to Point B in the most direct way possible because gravity compels it to. If asked to describe the Nile River, for example, we might simply say that it begins in the highlands of equatorial Africa and ends somewhere outside Cairo before emptying into the Mediterranean Sea. That description works because our outcome-oriented brains tend to think in terms of straight lines — in our need to simplify and explain, we tend to ignore the small differences in geography, soil composition and human engineering that create all the twists and turns that make the Nile as much a fixture in history and literature as it is in encyclopedias and on maps.

Markets work pretty much the same way. When we hear that the stock market is "down 30% from its peak," we tend to assume the fall was rapid and uniform: a flood of risk aversion rushing downhill, sweeping away everything in its path as gravity compels it to seek its new lows as quickly as possible. But like our over-simplified description of the Nile, this vision ignores all the tiny (and a few not-so-tiny) influences that can create enormous twists and turns along the way. Substitute things like Fed policy, short interest, delta hedging, and irrational exuberance for soil composition and hydropower projects in the analogy above, and you get a pretty apt description of the market's twisty path so far during the COVID-19 pandemic.

Source: Morningstar Direct, Bloomberg and GWI calculations

So, why does this matter? Because the sudden and dramatic decline in markets related to the ongoing COVID-19 crisis and efforts to slow its advance may have tempted investors to leap out of the way and shelter in place until the deluge passes. And that, like most investment decisions motivated only by fear, would likely have been a mistake.

Consider what would have happened if you had implemented a simple trading rule when the pandemic-inspired deluge began back in late February. Let's say that following any day when the S&P 500® Index fell by 3% or more you had de-risked your portfolio by going to 100% cash. You then held that high ground until things improved; say, until the S&P 500® Index gained 3% on the day, at which point you re-entered the market. (Those thresholds are admittedly arbitrary, but they seem at least somewhat reasonable because during the 10 years leading up to the COVID-19 crisis, markets fell by -3% or more only about twice per year on average.)

Most readers will obviously realize how poor a strategy this would be. In addition to the near-impossibility of precisely nailing the timing and setting appropriate gain/loss thresholds exactly right (something even professional investors consistently fail to do), it would subject our headline-obsessed investor to unnecessary trading costs and a whole range of other return-eroding evils. But it nonetheless illustrates a key point for investors to consider when facing a sudden spike in market volatility: It's often better to react calmly and with discipline than it is to panic and trade blindly in reaction to the latest headline.

So how would this "strategy" have fared during the COVID-19 crisis? Sure, selling at the first sign of trouble (namely, the 3.4% drop on February 24) would have spared you from two more 3%-plus drawdowns that occurred that week, but it also would have left you uninvested for some of the biggest interim recoveries that happened after that (like the massive 9.3% rally on March 13). Moreover, blindly following this rule would have compelled you to buy back in immediately after that very same rally on March 13, just in time to suffer a historic 12% loss the following trading day. Simply put, you would have been whipsawed — and not just once, but over and over again. (Moreover, this trading rule would have generated a whopping 15 trades — eight sells and seven buys — in a mere two and a half months.)

Hypothetical results of different trading strategies during the COVID-19 crisis
February to mid-May 2020

	BEGINNING VALUE	ENDING VALUE	RETURN (%)	SELL THRESHOLD	BUY THRESHOLD	# OF SELLS	# OF BUYS
Buy-and-hold	$100	$88.44	-11.6%	N/A	N/A	—	—
Model 1: (3x3)	$100	$77.95	-22.0%	-3%	+3%	8	7
Model 2: (5x5)	$100	$82.83	-17.2%	-5%	+5%	3	3
Model 3: (3X5)	$100	$89.05	-11.0%	-3%	+5%	5	4
Model 4: (5x3)	$100	$71.29	-28.7%	-5%	+3%	4	4

Of course, with perfect hindsight and better-than-average spreadsheet skills, it's possible to "tune" this kind of model into results that, in retrospect, would have fared better than our simple model and perhaps even beaten a simple buy-and-hold strategy. Results of such an exercise appear in the table above, but this still leaves completely unanswered the question of exactly how you would have arrived at those thresholds beforehand.

The point is this — equity prices, like rivers, never move in a straight line. Big drops are inevitably followed by big recoveries, and vice versa, even when the market's overall trend is well-established. Whether these twists and turns are the result of Fed liquidity injections, rumors of potential cures for the virus, or any number of other stones in the riverbed, the result is often the notorious "whipsaw" that investors suffer when they are tempted look to yesterday's close for cues about what it might mean for tomorrow's open. In the end, most investors will likely be far better off by simply sticking with their original course and riding through the rapids to calmer waters.

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