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Investing in Equity Market is Simple, but Not Easy

Expert Take

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After a remarkably stable 2017, there has been a sharp rise in volatility in the equity market since the beginning of 2018. There has been a sharp correction all across particularly in the broader market. As usual, in hindsight we all know the explanatory factors for such a broad based decline. Rising oil prices, sharp jump in global and domestic interest rates, a strong US dollar, few regulatory changes pertaining to domestic equities, incidents of corporate misgovernance, domestic liquidity concerns, etc. The reasons are aplenty.

The fall of 2018 has particularly come as a jolt because it's been preceded by a rather serene 2017. Last year was great for the market not only because the broader market enjoyed a very strong rally, but also because there was hardly any meaningful correction during the year. In fact, not even a 5% correction in the Sensex. A rare feat. In 2018, we are seeing some payback of that exceptional calmness.

What's been happening in the market now is certainly not pleasant but at the same time it's very normal in the longer time frame. Since 1990, i.e, in the last 28 years, the Sensex has given negative annual returns in 10 years. So on average nearly 1 out every 3 years market has delivered negative returns. Further, on a monthly returns basis, more than 40% of the time the Sensex has delivered negative returns. History suggests that notwithstanding the phenomenal wealth creation over the long periods, most markets, sectors and companies which have seen prolonged bull run have seen massively sharp corrections in the interim.

Fluctuations are a normal part of investing. The best way to deal with volatility is to stay the course and ignore short-term gyrations. However, that's not easy to practice by everyone. In reality, higher volatility leads to anxiety and that often leads to wrong investment decisions. As emotional beings, we extrapolate our current emotional state into the future. There has been various studies conducted in India and elsewhere which try explain that why an average investor earns less than the market over the long term. As per the US-based Dalbar Inc, an average American equity investor has earned significantly less than S&P 500 index across time periods. And the reason is "emotional biases".

More practical way to deal with volatility is to mitigate the stress through proper asset allocation. Harry Markowitz called diversification "the only free lunch in finance." Advisors have been doing a great job in terms of helping the individuals in terms of rightful asset allocation, where there is a proper mix within asset classes like bonds and equities. Within equities too, a right balance is desired where based on the risk tolerance, investors should choose between large, mid and small cap stocks. What is really heartening is the way Indian investors have behaved in the last 6 to 9 months of volatile markets. In September alone, mutual funds garnered ₹7,727 crore of assets via SIPs, a growth of 40% year-on-year. Considering that market is far more attractive now after the correction as compared to the beginning of the year (trading near average historical valuations), the odds of making superior returns in the times to come have improved.

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At a more fundamental basis, there has been lots of adjustments that has happened in the form of weaker rupee and higher interest rates. Above all, there are definite signs of broader earnings recovery taking place. Asset returns are cyclical in nature. That's the ultimate truth. The stock market will recover and move higher. It always does. However, the period of uncertainties will prevail. We have upcoming general elections and then there are global events like the US-China trade war, Italian crisis, oil politics, etc which would keep the volatility alive in the foreseeable future.

While asset allocation should always command great importance, in an uncertain environment like this the virtues of asset allocation/diversification come to the fore. So staying focussed towards long-term objectives and adhering to best suited long-term asset allocation strategy will continue to yield great results.

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