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Five rules for investing in volatile times

From the Field

Key Insights

- The financial crises of the past offer useful lessons for investing in periods of heightened volatility.
- Remaining invested, understanding everything you own in your portfolio, and avoiding the temptation of trying to call the bottom of the market have been crucial.
- Truly great companies are rare, and opportunities to buy them at great prices are even rarer. Be on alert for when they are "on sale."

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The Trump administration's seismic policy shifts and the sharp swings in the market, coupled with declining economic indicators and rising geopolitical tensions, sent me down memory lane for useful lessons from some of the most challenging times of my career.

This remembrance of crises past included the 1990s recession, the Asian financial crisis in 1997, the collapse of Long-Term Capital Management, the 2008–2009 global financial crisis, the 2011–2012 European sovereign debt crisis, and the shutdown of broad swathes of the global economy during the coronavirus pandemic. What can investors learn from these extraordinarily difficult market environments to help them navigate periods of heightened volatility and economic stress?

Lessons from market crises of the past

Here are five suggestions to help you survive the market's gyrations and thrive afterward. The key is to stay calm and focused on the long term.

1. Be patient and know your competitive advantage.

It is natural to look at your entire portfolio at once and think that getting market direction right is the only thing that matters and that fundamental security analysis is pointless. This is incorrect. A deep understanding of companies can give investors the confidence to buy in the scariest markets. These moves should ultimately be rewarded when conditions improve. Use a longer-than-average lens to view the world in front of you, and stay focused on what matters.

2. Use volatility to your advantage.

When volatility becomes extreme, markets become disorderly. Avoid wholesale portfolio changes as I'd say your chances of getting it right are around 50% minus trading costs, which, incidentally, will be elevated. Conversely, extreme dislocation at security level pricing provides opportunity, assuming you have done your homework.

3. Avoid precision.

You cannot pick the exact bottom, so why beat yourself up about it? It is easy to start the day with optimism only to look foolish by midafternoon. Nobody, no matter what they claim, has the power of precognition—so avoid becoming obsessed with it. Being approximately right is better than being precisely wrong. Averaging in is a valid strategy.

4. Stay invested.

Keep embracing risk and remain invested and diversified. When reversals occur, they are often powerful. Much of the potential upside tends to come in a limited number of trading sessions, making it difficult to reinvest in time. In all the bear market cycles since the 1990s, the inflection point only became apparent with the passage of time. No bell is ever rung to signify the bottom.

5. Accept the world has changed and challenge your own assumptions.

Do not get anchored to the prices from which stocks have fallen. You cannot trade at yesterday's prices. In security selection, we are always making a relative bet. We therefore need to understand how the relative earnings power of companies has changed and, where appropriate, sell low to buy low. In behavioral terms, this is a hard thing to do.

The challenges of today

Bear markets tend to bucket into three types: event-driven, cyclical and structural—in descending order of duration. The diagnosis here would appear to be event-driven turning into a cyclical issue with a prognosis of medium-term duration as the market comes to terms with what tariffs mean for earnings and inflation.

The extremely aggressive tariffs that the Trump administration unveiled on what the president dubbed "Liberation Day" were a shock to the global economy and, potentially, the world order.

It was a seminal moment.

Even with President Trump announcing a 90-day pause on so-called reciprocal tariffs for much of the world, the remaining 10% across-the-board levy is still a significant increase relative to what was in place at the start of the year. And that says nothing of the escalating trade war between the U.S. and China or President Trump's threatened tariffs on copper, lumber, pharmaceuticals, and semiconductors.

From my vantage point, extreme tail events—for example, a complete withdrawal of tariffs or the economic Armageddon that could follow a total decoupling of China and the U.S.—appear unlikely. However, the middle path, which is likely to be paved with permanently higher tariffs and further trade negotiations, is still winding, and visibility is hazy.

Economic orthodoxy would tell you that tariffs are likely to be inflationary and that the hit to demand would cause meaningful damage to the U.S. economy and around the world. That said, there is very little about policymaking now that is orthodox.

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If we enter a recession, the tactical response of favoring defensive sectors, such as utilities, health care, and consumer staples, likely still holds from the old playbook. But we also need to be strategic and factor in potential structural changes. Europe, for example, appears to be heeding its wake-up call and is increasing defense spending, opening the door to fiscal stimulus, and operating more as a unified market.

Now, more than ever, investors must be calm and rational. We need to remain detached from all the noise on social media and be among the seemingly small percentage of market participants who remain calm, confident, energized, focused, knowledgeable, and anticipatory.

A final reminder

Truly great companies are rare. A 2016 study by Hendrik Bessembinder at Arizona State University, for example, found that from 1926 through 2015, just 86 stocks out of 26,000 examined accounted for 50% of the market's return. The top 1,000 companies (less than 4% of the total) accounted for 100% of the wealth creation during that time.

Chances to buy great companies at great prices are even rarer—we believe in taking a shot when the opportunity arises.

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