

What is Market Volatility?

The value of your investments can change over time, sometimes unexpectedly, as a result of changes in the market. It is normal for the market to fluctuate. It can go up or down.

An investment with a price that changes quickly and often is considered more volatile. If you have an investment with a price that stays consistent, it's considered to have low volatility. High volatility generally makes an investment riskier, and it also means a greater potential for gains, or losses.

Market volatility can happen for different reasons and can be hard to predict. The market may fluctuate because of:

- Human factors, such as supply and demand.
- World events, like natural disasters or conflict.
- Shifts in investor sentiment towards or away from particular companies or economic sectors.
- Overall changes in the economy.

There are many factors that can affect investment prices, which can cause small or large changes in market activity. Changes in market activity can affect the value of stocks, bonds, ETFs, as well as mutual funds and other investments not directly traded on the market.

When determining the volatility of a particular investment, it's not enough to just look at its price change from one day to the next. It's a good idea to look at the largest monthly or quarterly loss it experienced, as well as the largest gain.

The COVID-19 pandemic is an example of an event that caused significant market volatility. When the pandemic hit, there was a sharp drop in the market followed by large swings in value as investors received new information about the economy.

What is a market bubble?

A market bubble is a significant market fluctuation. Imagine blowing a soap bubble that grows larger and larger. Eventually it cannot grow any larger and pops. In market terms, this happens when the price of a stock or other asset escalates in value very rapidly or beyond its true value.

Market bubbles can start gradually, as investors start taking interest in a new product, company or industry. As demand grows, momentum shifts towards speculative investing as more people herd towards the same investment. As the investment's value continues to climb, it reaches a point of having more speculative value than intrinsic — in other words, the value has increased well beyond the worth of the asset. This means the investment has become overvalued and the bubble is at risk of bursting.

A bubble burst is characterized by a sudden, significant drop in prices for that part of the market. Investors may panic and sell as prices drop, causing prices to fall further. One example of this is the dot-com bubble of the 1990s, when stock prices in the technology sector grew significantly. The bubble then burst in 2001 after many dot-com businesses failed to make expected profits.

How do behavioral biases influence investors during market bubbles?

It's common for people to be influenced by behavioral biases when making financial decisions. If you are aware of your biases, you can try to avoid making decisions based on irrational or emotional behavior.

An important behavioral bias to be aware of during market bubbles is herd behavior. Herd behavior occurs when you do what others are doing, rather than making decisions based on your own knowledge and information. Market bubbles tend to grow because of speculative investing behavior, when many investors follow the crowd, even if it doesn't make rational sense for their own investing plans.

Confirmation bias can often lead to participating in herd behavior. ***Confirmation bias is the tendency for people to interpret situations in ways that confirm their existing beliefs and dismiss information that might challenge those beliefs.*** During a market bubble, an investor might notice the behavior of the crowd and interpret this as confirmation that they, too, should buy the investment.

If you catch yourself following the herd and making impulsive choices during times of stress, try to take a step back and remind yourself of your financial goals. Ask yourself honestly whether this new decision will help you in your long-term plan. Also, take a moment to revisit your past mistakes. Have you been wrong in the past, even though you felt confident at the time? The potential negative effects of behavioral biases can often be countered by taking a moment to pause and giving yourself a reality check.

It's easier to stick to your plan if you have one in place. Get started with these tips on making an investment plan.

How can you manage volatility as an investor?

It's likely that your investments will go through periods of volatility, especially if you are invested in the market for the long term. Some investments, like stocks, can move dramatically up or down from one day to the next. As a result, your investment returns can also vary, showing positive or negative returns depending on exactly when you buy and sell.

Be prepared for the times when market swings happen. There is no single way to respond to these moments. However, a well-defined investment plan tailored to your financial goals and financial situation can help you be ready for the normal ups and downs of the market, and opportunities as they arise.

Consider these tips for managing volatile markets:

- Stay the course with a diversified portfolio
- Trying to time the market often leads to losses when prices drop, and opportunity costs when prices start to go up. You may consider holding on to your investments during market volatility depending on your investment plan and time horizon
- By investing in a diversified portfolio, you can mitigate the risks associated with market volatility. That's because generally all investments don't go up and down at the same time or by the same amount.
- Spread out your risk by making regular investments – Dollar-cost averaging is one way to manage the impact of volatility. By investing a set amount regularly, such as weekly or monthly, you can average out your investment costs. You also avoid the risk of investing a larger lumpsum at a time that may later turn out to be the peak in value, just before a downward market swing.
- Stay focused on your long-term goals – It can be hard to keep a level head when markets are turbulent. Try to avoid impulse decisions you may regret later, by focusing on your long-term investing goals. If you sell during market downturn, those losses will be locked in. Instead, stay focused on your personal financial plan. Keep the big picture in mind and resist the herd mentality that can accompany speculation that comes with market bubbles.

I hope this explanation will dispel any day-to-day anxiety that you may experience.

Warmly,
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