

## NORTHERN EXPOSURE

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# Heat of the Fire

Investors can prepare for future market volatility by revisiting their experience from past market declines. Brad Steiman discusses the value of conducting a “financial fire drill” and offers portfolio illustrations to help set client expectations.

Financial advisors can enrich their clients’ wealth and personal well-being in many ways. In the investment realm, advisors can greatly improve the overall financial experience by setting the right expectations *before* a market decline and encouraging discipline *during* a decline.

The stability of net cash flows in Dimensional’s equity portfolios vs. the mutual fund industry as a whole may be a testament to the indispensable service many advisors provided their clients by counseling discipline and patience during the global financial crisis.<sup>1</sup> Clients who didn’t capitulate to the onslaught of bad news that accompanied price declines should be grateful that they stayed the course.

However, this is not the time to be complacent or bask in the glow of past victories. Instead, you might revisit the ways you helped clients stay disciplined in the last market downturn and then begin to set expectations for the next market test, whenever it may occur.

In his *Wall Street Journal* column, Jason Zweig recently asked readers if they are ready for the next market crash.<sup>2</sup> Citing a series of published experiments, he observed that the stress of a collapsing stock market fundamentally changes how people make financial decisions. These experiments likely validate your own observations of how clients can change their thinking and behavior in a dramatic market decline. The question is what you can do today to mitigate emotional investment behavior triggered by a future downturn.

1. Based on quarterly fund flow data from 2008 through 2012. During the period, net new cash flow for Dimensional’s US-domiciled equity mutual funds totaled \$33.4 billion, compared to a negative \$535.5 billion for the industry. Dimensional estimated net flow data provided by Morningstar. Industry net new cash flow data provided by Investment Company Institute based on the approximately 4,600 US-domiciled equity (domestic and international) mutual funds reported on an aggregate level to the Investment Company Institute. This includes information on Dimensional’s US-domiciled funds during this period as well.

2. Jason Zweig, “Are You Ready for the Next Market Crash?” *Wall Street Journal*, June 13, 2014.

**INVESTOR FIRE DRILL**

In a recent blog post, Dan Wheeler advocates conducting the equivalent of an investor’s fire drill with clients so they can learn what to do when the real thing happens.<sup>3</sup> We all know the purpose and value of a fire drill, although few people approach it seriously due to the low odds of experiencing a real fire. On the other hand, most investors regard a future market decline as highly probable even if they don’t know when it will occur, why, or by how much. Yet, few prepare themselves for how they will feel when their account values are falling.

A financial fire drill can demonstrate the frequency and magnitude of market declines—and reinforce the point that global markets have always recovered. The exercise emphasizes the value of being disciplined and the opportunity cost of bailing out at the wrong time. Considering the recent market turbulence, the time may be right to remind your clients of the emotions that may arise in a downturn. The following illustrations might help.

**Exhibit 1** shows how the MSCI World Index weathered the past five major market declines of at least 20% back to the 1970s. On average, a downturn of this magnitude occurred every eight years, with the index declines ranging from 20.5% to 54.0% and lasting from three to 30 months.

Consider the impact of the smallest decline (1987) and largest decline (2007-09) on the MSCI World Index (periods indicated by bold text). A million

dollars invested at the market high point in August 1987 would have fallen to \$795,274 by November 1987, and \$1 million invested in October 2007 would have fallen to \$459,709 by February 2009.

Now consider the index’s recovery in both periods. Five years after the 1987 high, the initial \$1 million index value would have been worth \$1,122,892 (August 1992); the 2007 index would have recovered to \$864,642 (October 2012). Finally, consider the value of the index five years after its low in these two periods. The initial \$1 million invested in 1987 would have a value of \$1,100,767 by November 1992; the 2007 investment would be worth \$1,142,808 by February 2014.

This exercise provides useful information that may help investors navigate a challenging market environment. Unfortunately, drills of any kind are never the same as the real thing. A fire drill can remind you to head for the closest exit, use the stairs, and walk to strategic gathering points—all useful information that may help you get out alive. But going through the motions will not replicate the noise, chaos, and heat of a real fire. Would you behave differently in a real one?

Like the fire drill, featuring the data alone may not summon the anxiety of an actual event. To replicate the stress, investors must feel the heat, which, according to researchers, is what triggers a change in investment behavior.

**Exhibit 1 MSCI WORLD INDEX PERFORMANCE**  
Past Five Major Market Declines (1973–2009)

HIGH	LOW	MONTHS	TOTAL RETURN	VALUE OF \$1 MILLION INVESTED					
				AT LOW		5 YEARS AFTER HIGH		5 YEARS AFTER LOW	
Mar 1973	Sep 1974	18	-41.1%	Sep 1974	\$589,308	Mar 1978	\$954,069	Sep 1979	\$1,251,259
<b>Aug 1987</b>	<b>Nov 1987</b>	<b>3</b>	<b>-20.5%</b>	<b>Nov 1987</b>	<b>\$795,274</b>	<b>Aug 1992</b>	<b>\$1,122,892</b>	<b>Nov 1992</b>	<b>\$1,100,767</b>
Dec 1989	Sep 1990	9	-24.3%	Sep 1990	\$756,622	Dec 1994	\$1,197,426	Sep 1995	\$1,379,932
Mar 2000	Sep 2002	30	-46.8%	Sep 2002	\$532,005	Mar 2005	\$864,820	Sep 2007	\$1,284,615
<b>Oct 2007</b>	<b>Feb 2009</b>	<b>16</b>	<b>-54.0%</b>	<b>Feb 2009</b>	<b>\$459,709</b>	<b>Oct 2012</b>	<b>\$864,642</b>	<b>Feb 2014</b>	<b>\$1,142,808</b>

In USD. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. MSCI data © MSCI 2014, all rights reserved.

3. Dan Wheeler, “Fire Drill,” Wheeler Writes blog, July 1, 2014, <http://wheelerwrites.com/2014/07/01/fire-drill/> (accessed October 1, 2014). Dan Wheeler was Director of Financial Advisor Services at Dimensional Fund Advisors LP from 1989 to 2010.

Most clients have never experienced a real fire, but almost all have been through at least one, if not several, of the market declines summarized in Exhibit 1. Their real-life experience presents an opportunity to take the financial fire drill a step further. By combining high, low, and subsequent index values with anecdotal headlines, you can re-create the thoughts and feelings your clients may have experienced at that time.

This idea is illustrated in **Exhibit 2**, which graphs monthly values of the MSCI World Index during the 2007-09 market decline and over the five years following the index's initial high and low. Select headlines from *TIME* magazine cover stories are featured as artifacts of the popular sentiment during that period. While these headlines do not suggest causation of the market movements, they offer a sampling of the issues highlighted by the media during that time.

If your clients stayed disciplined in the past, they hopefully will stand firm in the future. But don't assume so. Their

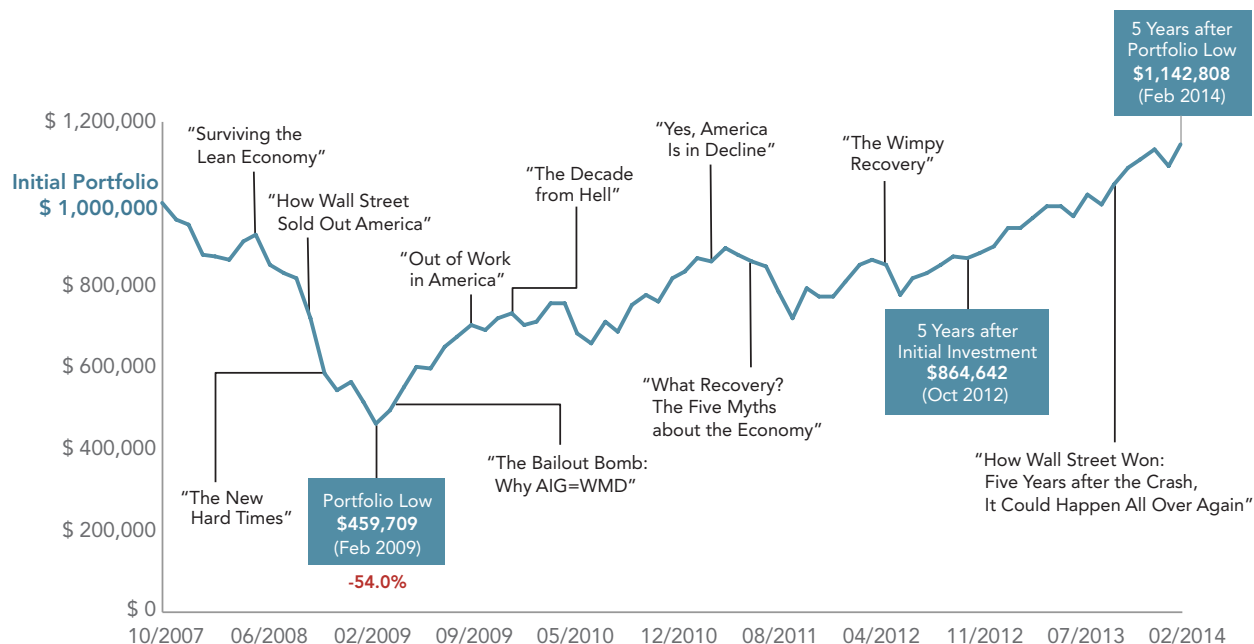
stress will likely return since falling stock prices often come with a slew of bad news and create an uneasy feeling of not knowing when the pain will end and whether "this time is different."

However, they may take solace in knowing that you have designed their portfolio to account for challenging markets through a suitable asset allocation based on their unique needs and preferences. Drills help prepare clients for what to do when the fire starts, but prudent portfolio design aims to prevent the temperature from getting too hot to handle.

Setting expectations requires a delicate balance between preparing clients for an eventual market decline and stoking fears by appearing to predict that a decline is imminent. This is when your perspective and communication skills can pay off. As renowned Canadian physician William Osler said, "the best preparation for tomorrow is to do today's work superbly well."

**Exhibit 2 MSCI WORLD INDEX PERFORMANCE**

Growth of Wealth and Select *TIME* Cover Stories, October 2007–February 2014



The cover stories above are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a longer-term perspective and avoid making investment decisions based solely on the news.

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The MSCI World Index measures the performance of securities from developed markets. It is not an investment product available for purchase.

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