The Startle Reflex
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When you’re startled you react reflexively – you jump, you blink, you move in a way to protect yourself. We all know the feeling: something startles us and we move without thinking, and without any real control over ourselves. Of course, the reason for these reflexes is self-protection, and it would be dangerous not to have them. But at the wrong time and in the wrong circumstances these reflexes can be harmful. If we are driving, and someone in the back seat decides to burst a balloon everyone involved is likely to have a bad time.

Biology is inexorable, however, and the same behaviors can be observed in the capital markets - particularly the way in which markets respond to unexpected news, or news that is poorly understood. A sudden event that catches the market by surprise, leading market participants to have to try to think quickly and accurately to judge the impact of the event, is hard to deal with. At such times we all tend to display the Startle Reflex. We think viscerally rather than intellectually, we predict the future based on mental models of the past, we suffer a failure of imagination as to the potential implications of the events, and we allow emotions to drive our thinking more than they should. If lucky, we are simply confused or scared into inaction – if unlucky we can end up either panicked or euphoric, neither of which are good investment words.

Letting ourselves be governed by the Startle Reflex is a bad idea in general, and a terrible way to run portfolios in particular. Below I outline a number of situations where the market was startled by news, but where an immediate response would have been unhelpful. I then suggest how investors might approach this type of situation when running portfolios, and how these situations might be used to one’s advantage, rather than to one’s disadvantage.

The conclusion? Think strategically, then tactically. Only react at the strategic level when the core risk premia you are trying to harvest have changed their nature materially – react tactically only when you are highly confident that you have clear evidence of a tactical opportunity, when it will end, and the decision process you will use to move back towards your strategic position.
Brexit

Our first example is the Brexit vote this summer regarding whether the U.K. would remain in the European Union.

The result was surprising to many, especially to market participants and the journalistic community. The U.K. is even more centralized than the United States, where at least the political and financial capitals of the country are separated by a train ride. In the U.K., London is much more the center of everything. Market commentators, journalists, and politicians all know each other, live in the same neighborhoods, have children in school together, and often share a similar worldview. The idea that a vote to withdraw from the European Union was even possible was simply unthinkable within that closed group of people. Even those who might have chosen to vote to withdraw in private often censored their views carefully to ensure that they were not perceived as outsiders. This consensus, which was supported by the viewpoint coming from many international economic institutions, drove much of the discussion, and backed up most of the economic forecasts that were used in the debate. Everyone knew that the result of a “leave” vote would be apocalyptic for the economy – but the constant repetition of these forecasts by the backers of the remain campaign didn’t run true in much of the country, and the models used to produce the forecasts relied heavily on assumptions. One of the leaders of the “leave” side, Michael Gove, said during an interview, “people have had enough of experts”. He wasn’t meaning of course that there was no place for expert analysis and discussion, but instead simply that the current group of experts weren’t actually expert. They were caught up in the way they would have liked the world to be, and with models based around these assumptions. This consensus spilled over to the polling companies too, leaving many involved blind as to the real facts on the ground.

When the vote happened, then, there was a cataclysmic moment of self-doubt. “Remain” voters had failed to bother to construct a realistic mental framework to use in case of a “no” vote. Once this was the reality they had to deal with they found themselves lost – and lost, in many cases, at a trading desk with decisions to make.

We can see the result in the chart below. While the initial reaction was to the downside, U.K. equities rapidly began to outperform expectations, leading the way amongst European markets. The pound devalued, but this devaluation in itself significantly improved British terms of trade with the rest of the European Union. The economy continued to plow ahead, with good growth numbers being reported and many companies announcing that they would continue to support the U.K. as a place to do business.

**POST-BREXIT EUROPEAN EQUITY MOVEMENT**

![Chart showing post-Brexit European equity movement](source: Bloomberg, 6/23-12/5, indices shown in local currency)
The story here, then, is simple – through lack of open-mindedness and failure of imagination the market as a whole failed to really understand how an event that was thought of as being unlikely would in fact affect prices. The immediate reaction didn’t match the subsequent reaction. The mental models that most people had constructed failed to explain the vote, and failed to explain the outcome. Rapid “obvious” responses would have been very costly to investors.

Kobe

A second example is the market behavior following the Kobe earthquake of January 1995. Earthquakes are the perfect example of unpredictable events that markets find hard to measure – the degree of damage can’t easily be predicted, and the problems of immediate loss are offset by the fact that the subsequent economic activity can act as a boost to the local economy. The easy assumption by investors would be that the event would have negative effects on the Japan equity market. In many ways, however, the important effect of the earthquake was seen in a seemingly unrelated location – the rapid failure of Barings Bank, with potential knock-on consequences for financial markets and financial services companies around the world. The bank had been exposed, through fraudulent activity by a senior employee, to massive hidden directional positions, which caused huge losses with the falling Japanese market. 1.

While the rapid purchase by ING of the failed bank ensured that the failure didn’t cause the potential counterparty damage that could have happened, nobody could have expected this result to have been caused by an earthquake on the other side of the world.

Once again, the initial reaction was incorrect – investors following the Startle Reflex would have missed the real story.

President Trump

The third example we will cover is that of the recent election of President-Elect Donald Trump.

Similar to the Brexit vote, this came as a big surprise to many in the market and commentary community. In the run up to the vote, few were prepared to discuss in public, or in responsible financial circles, the

possibility that he might win the election. The reasons were similar to those cited in the Brexit vote – an insular press who had failed to stay in touch with a developing mood across the country, and an economic and market modeling community who had failed to enquire often and deep enough as to the true impact of an unlikely event.

Note I’m not commenting on whether his election was a good or bad idea, or whether his policies will be effective or otherwise – simply on the degree to which the market participants had prepared themselves to understand the implications of him winning.

The immediate result of the Trump victory was a sudden large drop in many markets. The presumption throughout the investor community had been in the run-up to the election that a Trump win would be bad for markets, and so the initial Startle Reflex was to sell. Fascinatingly, however, this reaction was very short-lived. Almost immediately the market reassessed the impact of the win, and began to rise significantly. Some of this movement may simply have been due to the removal of uncertainty from the market, some may have been from the beginning of an assessment of the possible positive components of his policy agenda (possibly combined with difficulty in assessing the negative impacts as easily) and some may have been the reaction of Trump-leaning investors entering the market. The effect has been significant, though, and the resulting run up in market prices has been impressive. Market participants may disagree as to whether this is sustainable or not – but the presumed immediate positioning that might have been assumed to be optimal before the vote was by no means obviously the correct one in the light of day. Again, the Startle Reflex was a poor guide to profitable action.

What To Do

In each of these cases we can see that the Startle Reflex was wrong. Presumptions made before the event are often based on incorrect information, faulty models, or a failure (in the case of Kobe) to even understand the thing being modeled (Barings, not Japanese infrastructure). Complex events are difficult and time-consuming to analyze, and the instant reaction is unlikely to hold water often enough to be useful. What should we do instead?

We should begin with assessing the strategic issues. We should build portfolios from a strategic point of view, focused on the long-term exposures that are designed to give us the long-term return which we need, while only incurring appropriate levels of risk. Put more simply – the long-term view focuses on risk premia.
And when the task is phrased in this way, it becomes clear what question should be really asked about a
news event. Does the new information fundamentally change our understanding of the basic nature or the
rough scale of risk and return characteristics of the risk premia available in the marketplace?

When we buy the Equity Risk Premium, for example, achieving the point-forecast return we expect over the
long term will involve us experiencing both exceptionally good events and also very poor ones over time. The
important question is whether a good or bad event is so unusual that it fundamentally changes our view of
the total outcome expected from the risk premium concerned.

A good way of thinking about this is to use the structure of the Capital Market Assumptions document that
we pull together each year. While the end result of the document is a series of point-forecasts of the return
of each asset class, the real meat in there is the process that we use to make these forecasts. Each asset
class is forecast using a number of building blocks – the expected drivers of portfolio return. For equity
markets, for example, we look at yield, historical average real earnings growth, inflation on earnings, market
repricing, and currency effects. We use the same approach in our scenario analysis tool, where we take
the same underlying drivers, while assuming they move for the better or worse using historical statistics
as a guide for likely behavior. The building blocks used in these tools can be used as a thought-guide when
assessing if a change has been strategic or not. The right question to ask isn’t “are equity markets likely to
do better or worse” but are instead “can we no longer use the historical behavior of the drivers of this asset
class as a guide for the future”.

What does this mean in portfolio terms? Unless an event entirely changes the nature of the risk premia
we’re exposed to, we should probably not change our strategic asset allocation significantly. Strategic
allocations are strategic, and should only change when the underlying drivers of the market change in a
strategic way.

We can then move on to the more tactical realm, and ask whether the new information might make us
reconsider existing tilts relative to our strategic policy framework. This is a decision where the burden
of proof is likely lower – appropriate tilts change through time, and they do so in reaction to changes in
pricing and valuations in markets. However, though the burden of proof is lower, we should still follow good
investment practice. For example, when we’re deciding to tilt the portfolio we should understand how we’re
going to define success and failure. Simply deciding to tilt a portfolio is easy – doing so effectively and
learning from the outcomes is hard. Again, the Capital Market Assumptions and Scenario Analysis tool can
be of use here. By running the tool with up to date data after the event being considered we can identify
any large moves in 10 year expected return, or changes in the underlying drivers behind that return which
could be expected to have major impact in the coming months. This might allow us to identify tactical or
intermediate shifts in portfolios, but such shifts should always be accompanied by a clear time frame and
rationale, along with a clear understanding of the situations where we would move back to policy, either
because the identified anomaly has been harvested or because we have been proved wrong by the market.

In both of these dimensions however, the strategic and tactical, there is a core presumption. It is often the
case that the most dangerous thing an investor can do is something: it is also the case that often the safest
thing that an investor can do is nothing. Our approach to managing shocks should not be afraid of this fact.
Conclusion

The Startle Reflex is vital in its place in the body – it protects against active injury. In portfolio terms the Startle Reflex is less helpful, although it may help ensure that investors identify areas of possible concern in their portfolios. Instead of simply following the crowd, and making the Startle decision, we suggest investors think about the new information that is available on a strategic dimension and on a tilting dimension, and if that information does in fact suggest either a strategic or tactical move any decisions should be made carefully, and clear metrics put in place to assess their success or failure.

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Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charter holder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is a member of the CFA Institute and the CFA Society of Seattle. Mr. Toner is a trustee of Charles Wright Academy, an independent co-educational school based in University Place, WA. He is also a board member at the Seattle Metropolitan Chamber of Commerce, where he co-chairs the finance & audit committee. Additionally, he is a member of the advisory board of the Washington Council on International Trade.