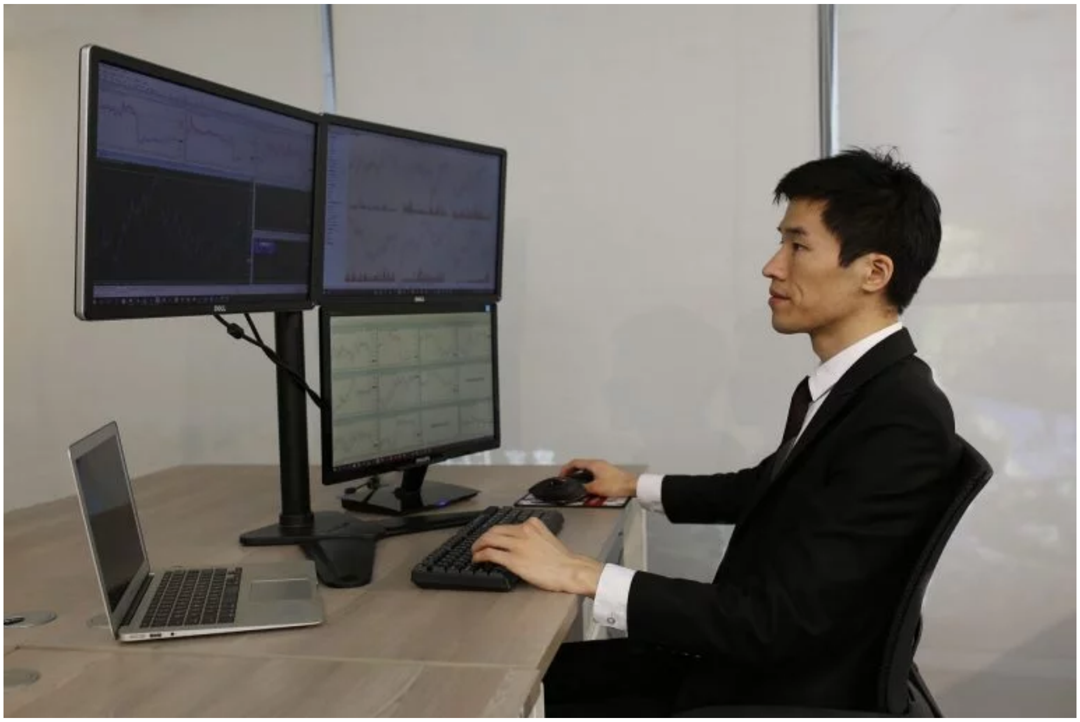
HOW TO TRADE IN EXTREMELY VOLATILE MARKETS

Zain Jaffer - Mar 18, 2020, 4:25 pm



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In times of extreme market volatility, such as what we are experiencing today with COVID-19, the playbook that you previously followed won't work anymore. The markets are clearly fear-driven with the Volatility Index (VIX) recently peaking at 82.6 – breaking the 80.74 record set during the 2008 financial crisis. Consumer sentiment, news events, and government press briefings are all contributing to the chaos. If you're anything like me, though, you know that that fortune favors the brave. However, you need to have a systemic trading plan and a few other things down to take advantage.

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Long-term investors cannot afford to sit still, hoping the crisis dissipates so we can enjoy the sky-high P/E ratios we were used to. As a multi-asset investor, I've had to make some tough decisions. This is the time to form a strong opinion and take critical action. You may have to do things that are uncomfortable, such as cutting your losses, rebalancing your portfolio or using aggressive financial instruments that you previously shunned.

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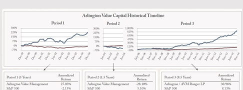

In the universe of mid-sized value orientated hedge funds, Allan Mecham of Arlington Value has to be one of the top ten performers of all time. Over the seven-and-a-half years to the end of 2015, the fund achieved a gross annualised return of 30.9% versus 8.7% for the S&P 500. 2015 was the first year Read More

Here are 5 guiding principles to keep in mind as you determine how best to proceed:

1) Form A Strong Opinion On The Future

My advice is to form a thesis on how you think the world will look in the short, medium and long-term. Write down some of the ways this story ends, and all the key assumptions driving those outcomes. Can this Pandemic die down? Will we enter a global recession? Try to back up your thoughts with credible references. Think about what data is questionable or what data might convince you to form a stronger opinion.

I know it's unnatural for some of you to form an opinion without reliable data, especially if you're analytical. This is the time to trust your gut and lean into your intuition. This is precisely why the VIX is so high - it measures fear. For my own portfolio, I am very bearish short and mid-term and somewhat bullish long-term. As we move forward, I could be swayed to change my stance if data emerges (outside of China) suggesting there won't be a "second-wave" of infections after containment controls are loosened.

2) Make A Strategic Plan And Stick To It: "Plan The Trade, And Trade The Plan"

After writing down your thesis and predictions for how you think the market situation will unfold, you need to determine your risk tolerance and what trading tactics match your thesis. You may form the opinion that the market will recover fast or that the markets have over-reacted. Having conviction behind such a thesis will give you the confidence to make moves when others are fearful, such as buying stocks or selling options against gold. If you don’t have any idea what’s going to happen, that’s still a strong opinion in itself. If you acknowledge this as an opinion, then it would make sense to rebalance your portfolio and go overweight on cash.

For the ~~Zain Ventures portfolio~~, I am bearish for 2020 but somewhat optimistic a year out. As a result, I’m compelled to make moves that match my thesis. For example, I’m actively short-selling the markets and pausing investments into travel-related start-ups. As interest rates fall to 0% I’m also turning to debt so that I can bolster my real estate portfolio.

Question every element of your financial plan. Does my portfolio allocation match my beliefs? Are my trades reflective of my stance? By writing a plan down, you can go back to that when you get nervous or concerned when the market swings against you and make whatever course corrections you need to make.

2A Stick with your trading plan

Regardless of your trading plan, it’s important to outline your objectives and follow the course. Developing a strategic plan and playing within the rules of that plan is the key to investment success.

Once I have determined a specific course of action, I stick to that plan; I don’t try to second-guess myself or waver. Be a stickler when it comes to your stops. The experts will tell you that you can get hammered by ignoring the rules you put in place when you were not in an emotional state. You can always get back in to a stock at a later date, but if a stop is triggered, sell your position. Hold on to your strategy, not an individual stock.

There are tools that you can use to help you stay true to your plan. For example, use limits so you are not always just staring at your screen. I’ve also set profit and loss levels that I’m comfortable with and that are not too close to upper or lower ranges. If you don’t want to actively trade, you can place capital with a Fund Manager that matches your investment objectives.

Having been a former Tech Entrepreneur, I do have a somewhat higher risk tolerance. I understand the upside potential of a certain level of volatility in the market, so I am making some riskier and tactical investments for potential higher returns. However, I offset that risk by building a diversified portfolio that can weather the storm over the long run while also allowing me to benefit from these higher risk opportunities.

3) Volatility Creates Opportunity

The markets are volatile because there is no central thesis that has prevailed. The markets are struggling to make sense of all the data that's coming out, which causes wild fluctuations in how assets are priced. There is opportunity to benefit from such swings, as long as you have a disciplined approach and utilize limit orders or stop losses with stocks or options.

Typically, much of stock trading happens by computer, with painstakingly-developed algorithms driving buying and selling…but when the markets are so volatile, emotions run hot and humans don't always trade in logical ways. This creates opportunity. It has been said that humans have an ability to make split-second decisions based on processing volumes of data in moments to arrive at gut-level inspirations in milliseconds. In the world of trading, time matters, and this environment creates an opening where human decision-making and gut level instinct can result in huge market wins for those poised to take advantage of volatile times.

In the past, I have been against day trading and technical analysis because it's hard to compete against the resources of institutional traders. However, this is a rare point in time, as the market is not behaving like it has in the past. Certain assets like bitcoin, bonds, gold or individual stocks are not behaving in the way the economists expected. This is somewhat driven by consumers making emotional decisions but also technology and algorithms. You can win big if you play these trends and make smart bets, especially if you chose to take a contrarian perspective.

If you are not actively trading, you might want to consider having exposure to hedge funds in your portfolio. Trust that the professionals can do it for you. Returns for hedge funds can be very high, and there are many examples of fund managers like Ray Dalio and George Soros who made have made billions that way.

4) Pay Attention To The News

It’s important to be aware of what’s being reported in the news regarding the market, especially in times of crises. Genuine, quality reporting will allow you to keep abreast of market shifts in near real time, allowing you to build on your thesis and adjust your trading plan when necessary. Focus on finding key data and credible research that tests the key assumptions you used to form your strong opinion. Separate fact from fiction; ignore the hype. Obviously, you shouldn’t be taking investment advice from your Uber driver or family members, unless they are professionals in the industry. Also realize, there are some financial shows that are really just meant as entertainment. Beware of financial news that instills fear and greed, as this will just distract you from your original plan; stay focused on data to challenging your assumptions.

5) Confer with other traders and advisors

Trading in turbulent times can make us feel fearful and drive us to make hasty decisions that we may regret. Naturally, it can be very helpful to study the financial investment strategies of proven experts who have navigated through such times, such as Warren Buffett and Carl Icahn (history will prove how they fare this time). When you are in the thick of it, it can help to have discussions with other traders and advisors who can help you interpret new data, especially to help you uncover blind spots in your logic.

Having access to a wealth manager is great, as they’ve likely seen it all. When I am unsure, I like to document my trading plan and share it with other investors, my wealth manager, and financial advisors to get their perspectives. Taking a step back and discussing with those I trust prevents me from making rash decisions and allows me to take a more thoughtful approach.

Trading plan conclusion

These are unprecedented times we are living through, which creates huge opportunities but also huge risks. By taking the time to think strategically about likely outcomes and basing your opinions (and therefore your trading plans) on logic and facts, you can develop a plan to trade dispassionately. Seek advice from those who have more experience and have seen other volatile markets that created huge opportunities for other traders. By following these guidelines, you can mitigate your risks while taking advantage of the possibilities for phenomenal upside to the current roller coaster market we are experiencing.

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Zain Jaffer is the Founder and CEO of Zain Ventures (https://zain-ventures.com), a global investment firm with over $100 million in assets under management. Zain Ventures invests in start-ups, real estate, stocks, fixed income, hedge funds, and private equity.

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