

Volume 43 //

Acuity

The greatest wealth is **your peace of mind...**



BARNETT
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WEALTH MANAGEMENT

Taking the downs with the ups



“ History does not repeat itself, but it often rhymes. ”

Mark Twain

Investors have experienced very strong investment markets since the Credit Crisis a decade ago. Some may have forgotten, or never experienced, the pain - and even fear - that such events can induce. When falls do happen, how investors behave will have a great bearing on the longer-term outcomes they will experience. Those who have fortitude, discipline and patience will fare best. Easier said than done. Those who need support should lean on their adviser – that is what we are there for.

It has been a while...

Today, £100 invested at the bottom of the global equity¹ market fall in March 2009 would be worth around £345 (before inflation and any costs). Those who lived through the Credit Crisis will remember it, but perhaps now with a dulled sense of what it felt like at the time, given the rebound in wealth that followed. Those newer to investing may never have experienced the sense of fear and panic that such a severe market fall can induce, and only ever experienced mainly positive outcomes.

It is important to remember that equity market falls are an inevitable part of the process of building wealth through equity ownership. This volume seeks to put market falls in perspective and offers some behavioural tips for surviving them.

Strong equity returns require market corrections and bear markets

Sometimes it helps to go back to first principles and remind ourselves why investors deserve positive returns from ownership stakes in companies (equities) and lending their money to governments and corporations (bonds): it is because the outcome that they will receive from their investments is uncertain.

The value of an investment is, in essence, the discounted cashflows that investors receive. The future dividend stream from equities is, intuitively, far less certain than the contractual payment of coupons (interest) and return of principal at the maturity date of a bond. The greater the uncertainty of the outcome, the more an investor needs to be compensated with higher returns. The market's view on the ability of a firm to deliver dividends – impacted by multiple factors, such as management strength, strategy, competition and the state of the economy – plus its perception of risk (reflected in the discount rate) – can have a large impact on the price of a share, leading to share price volatility.

If returns went up year-in, year-out, there would be no uncertainty of outcome and investors would be lucky to generate a return much higher than inflation. Longer-term investors should embrace – and learn how to survive – this shorter-term uncertainty, as it is the basis of strong longer-term equity returns.

You have to be in it to win it

Figure 1 illustrates the monthly returns of global equities from January 1999 to February 2018. The green bars represent the high point of the market before the Tech Wreck from 2000 to 2003 and the Credit Crisis from 2007 to 2009. The red bars represent the bottom points of the market.

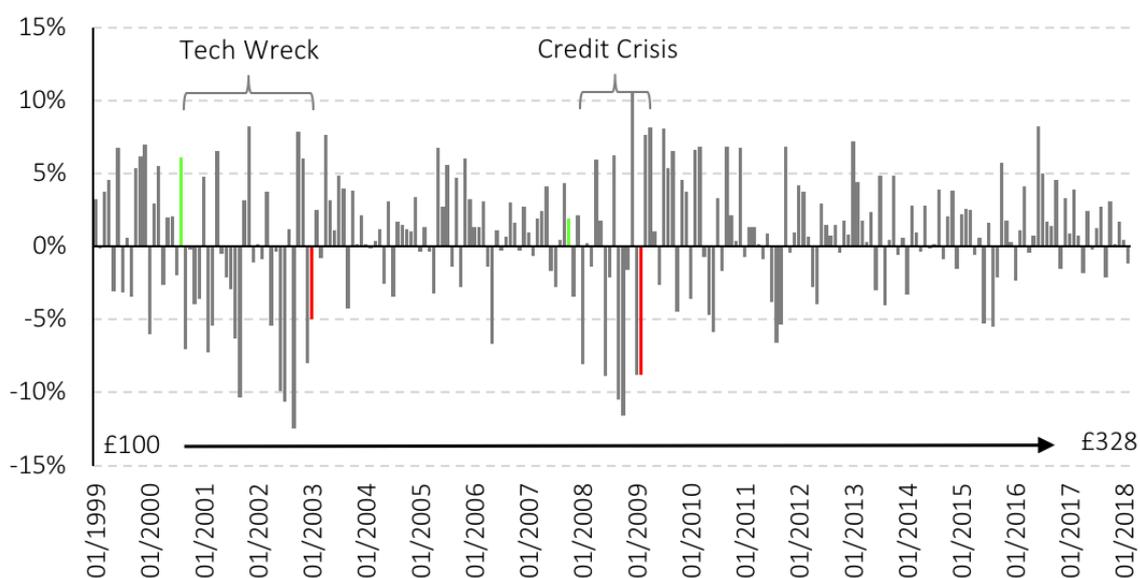


Figure 1: Global equity market returns are uncertain in the short run

Source: Albion Strategic Consulting. Financial Express © 2018. MSCI ACWI (net div.) in GBP 1/1999 to 2/2018.

Several noticeable observations can be made. First, markets are very volatile on a monthly basis. Second, there are almost as many down months as there are up months (140 up months from a total of 230 months). Third, hanging in there – through thick and thin – is a strategy worth pursuing; £100 invested in January 1999 more than tripled in value by the end of February 2018. It would be wonderful if someone rang a bell to tell investors when to get out of the market and rang it again to tell them when to get back in; but it is evident that picking the month, or even year, to do so is well-nigh impossible.

On the other hand, even if you had ‘got it wrong’ and invested at the very height of the market (the green bars in the chart above) before the Tech Wreck and the Credit Crisis, your £100 would be worth £232 (4.9% p.a.) and £227 (8.3% p.a.) respectively at the end of February 2018. The key message is to remain invested.

Figure 2 below illustrates how unsettling it is to look at the value of your portfolio too often. Even the data you see at a progress meeting with your adviser (e.g. six monthly or annually) is largely noise, and your portfolio is likely to be down on one in three visits to see them. As the time horizon extends, short-term falls recover, and even the material falls experienced during bear markets will wash out.



Figure 2: The longer the horizon the greater the chance of a positive outcome²

Source: Albion Strategic Consulting. Financial Express © 2018. MSCI ACWI (net div.) in GBP 1/1999 to 2/2018.

It is unfair to question the effectiveness of your portfolio or adviser based on short-term noise. Believe in the power of owning a diversified portfolio that is low cost and delivers you the market return for the risks that you take.

We can also see that the longer the time horizon, the lower the worst-case downside becomes. The numbers provided are cumulative return numbers, as annualised numbers can mask the true impact on wealth, particularly over longer periods. For example, a 2% annualised loss over 10 years is a cumulative loss of almost 20%. The worst 10-year horizon suffered an absolute fall of 9% (before inflation and costs), whereas the worst 3-year period suffered a fall of 45%.

Be brave. Be patient. Stay invested.



Figure 3: Maximum cumulative gains and falls over different time horizons

Source: Albion Strategic Consulting. Financial Express © 2018. MSCI ACWI (net div.) in GBP 1/1999 to 2/2018.

Fake news and true bear markets

Those participating day to day in the markets or commentating on them ('Billions of pounds wiped off UK shares' etc.), risk failing to see the wood for the trees and tend to induce feelings of panic, concern and sometimes even hysteria over short-term falls.

Much of the time, the doom mongering is overdone. Look at Figure 4 opposite; it illustrates that in every year there will always be periods when markets fall below their highpoint.

If we listen to this noise, we would spend most of our time being afraid of markets instead of embracing them. In market parlance, a 'correction' is deemed to be a fall of 10% or more and a 'bear market' is a fall of 20% or more.

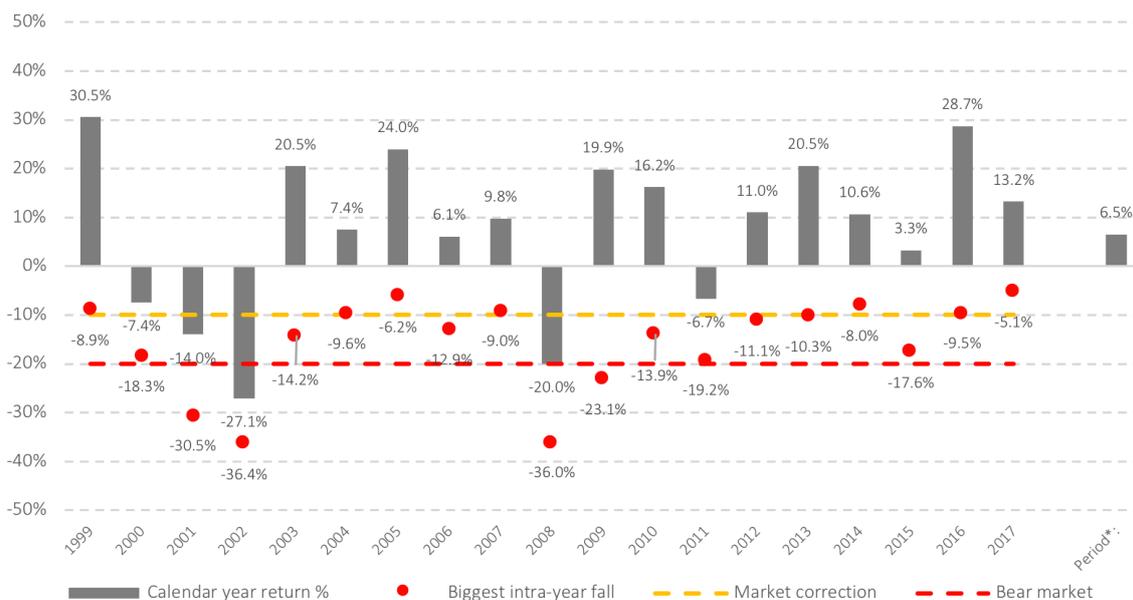


Figure 4: Every year, markets fall at some point during the year

Source: Albion Strategic Consulting. Financial Express © 2018. MSCI ACWI (net div.) in GBP 1/1999 to 2/2018.

Thirteen out of the nineteen years on show have delivered positive returns, despite suffering intra-year falls from the market high that year. Generally, investors should expect a down market one in every three years or so.

Look at 2009, as an extreme example: during the calendar year, the global markets suffered a loss of nearly a quarter of their value, yet finished the year up almost 20%. Selling out and missing the rise would have been extremely costly. Likewise, in 2016, the market fell almost 10% during the year, but ended up over 28%.

If investors panic when markets fall – perhaps switching into cash – they will inevitably suffer financially and emotionally on many occasions, when staying invested would have been the right thing to do. Responding to short-term market noise is to be avoided at all costs.

On some occasions, these falls can continue from one period to the next, turning from short-term noise into medium-term bear markets, some of which can be emotionally nerve wracking. The trouble is that by the time you can see that it is more than a very temporary downturn it is too late. Remarkably, and sadly, US investors in equity mutual funds made record withdrawals³ from the markets coinciding with the bottom of the markets (the red bars in Figure 1) during the Tech Wreck and Credit Crisis. Buy high, sell low is a strategy that guarantees wealth destruction.

If market timing were so easy, it would be simple to make vast amounts of money and there would be few professional fund managers left, as they would all be sunning themselves on their yachts in the Caribbean. It is not; and they are not.

Note to self: 10 things to remember as and when markets fall

It is an inevitable part of investing that at some point markets will fall by an alarming - if not unexpected - degree. We haven't seen large market falls for a decade. We should expect that we will. When, and in what magnitude, no-one knows. Remembering the following can help:

- 1. Embrace the uncertainty of markets – that's what delivers you with strong, long-term returns.**
- 2. Don't look at your portfolio too often. Once a year is more than enough.**
- 3. Accept that you cannot time when to be in and out of markets – it is simply not possible. Resign yourself to the fact. Hindsight prophecies – 'I knew the market was going to crash' – are not allowed.**
- 4. If markets have fallen, remember that you still own everything you did before (the same number of shares in the same companies, and the same bonds holdings).**
- 5. A fall does not turn into a loss unless you sell your investments at the wrong time. If you don't need the money, why would you sell?**
- 6. Falls in the markets and recoveries to previous highs are likely to sit well inside your long-term investment horizon, i.e. when you need your money.**
- 7. The balance between your growth (equity) assets and defensive (high quality bond) assets was established by your adviser to make sure that you can withstand temporary falls in the value of your portfolio, both emotionally and financially, and that your portfolio has sufficient growth assets to deliver the returns needed to fund your longer-term financial goals.**
- 8. Be confident that your (boring) defensive assets will come into their own, protecting your portfolio from some of equity market falls. Be confident that you have many investment eggs held in several different baskets.**
- 9. If you are taking an income from your portfolio, remember that if equities have fallen in value, your will be taking your income from your bonds, not selling equities when they are down.**
- 10. Your adviser is there – at any time – to talk to you. He or she can act as your behavioural coach to urge you to stay the course. They are a source of fortitude, patience and discipline. In all likelihood they will advise you to sell bonds and buy equities, just when you feel like doing just the opposite. Be strong and heed their advice.**

In conclusion

Owning equities in portfolios is not easy. Yet, the very nature of the uncertainty of outcomes is why decent returns can be expected from owning them. Markets will fall at some point and when they do, rely on the structure of your portfolio to see you through. Don't panic. If things get really tough in the markets and you feel stressed, go for a walk, have a drink, put on your favourite music and remind yourself of this information. Then call your adviser. That's what they are there for.

End notes

1. For the purposes of this volume, global equity markets refers to both developed and emerging market equities held in a market cap weight. The MSCI All Country World Index (net divs.) in GBP Index, has been used where figures are provided. All numbers are before inflation and any costs. The numbers are provided to offer a sense of magnitude and direction. They do not represent any product or recommendation of a product and are provided for educational purposes only.
2. These represent the number of time horizons, with a 1 month rolling interval, that observed returns were either positive (green) or negative (red).
3. Investment Company Institute - Yearbook 2017

Other notes and risk warnings

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