CFA SINGAPORE INSIGHTS

By Deepak Khanna

Position for the future by learning from the past

*"Those who do not remember the past are condemned to repeat it." – **Benjamin Graham***

WE are arguably in the later stage of the economic cycle, and further periods of volatility may lie ahead. When dramatic sell-offs happen, they can get aggravated especially in today's digitally connected world, often challenging investors' commitments to their long-term investment plans. While there is no fool-proof method to navigate extreme market volatilities, we can draw lessons from historical financial crises.

What makes a financial crisis?

If you recall "Black Monday", Oct 19, 1987, where we saw the single largest daily drop in the S&P 500 of more than 20 per cent. Or the 2008 financial crisis where we saw the S&P 500 having its single largest yearly drop in percentage terms since 1950, having dipped almost 39 per cent from the year before, surpassing previous historical lows recorded during the 1970s oil crisis and the 2000s dot-com bust. Such extraordinary sharp dips in global markets typically signal the onset of a financial crisis.

Despite different geneses, the pattern of a market crash is quite rhythmic – it usually takes place at the end of a sustained bull run, triggered by a root cause which ultimately leads to a sudden correction followed by panic selling either out of fear, formulaic trading or margin calls. In the case of the 2008 crisis, the prolonged fall in the market has led to systemic credit tightening and the eventual failure of some global financial institutions.

How should one react in a meltdown?

Market meltdowns are very much like earthquakes – we can't really predict them, but once they occur, we can ascertain the magnitude and epicentre with greater certainty. On most occasions, sudden market crashes are sentiment-led where investors realise the mispricing of securities vis-à-vis their intrinsic valuation and start to sell out. While inevitable, what goes down must come up, and markets will recover over time.

Tip 1: Keep calm

Short-term volatility is part and parcel of the investment journey. Remember that volatility is to be expected from time to time. Short-term volatility can occur at any time, but it does not necessarily derail long-term growth in stock markets. Historically, significant recoveries occur following major setbacks including economic downturns and geopolitical events (Chart 1). While headline-grabbing news can affect short-term sentiment and lead to reductions in asset valuations, share prices should ultimately be driven by fundamentals. Investors should avoid panic selling during volatile periods, to avoid missing out any potential market recovery.

Tip 2: Remain invested

Long-term investing increases the chance of positive returns. When markets get rocky, it is tempting to exit to avoid further losses. However, those who focus on short-term market volatility may end up buying high and selling low. History has shown that financial markets go up in the long run despite short-term fluctuations (Chart 2).

Though markets do not always follow the same recovery paths, periods after corrections are often critical times to be exposed. Staying invested for longer periods tends to offer higher return potential. Just to be clear – to remain invested doesn't necessarily mean "do nothing" – one should review one's portfolio and take action accordingly.

A learning experience

Chart 1: Financial markets have risen after financial crisis over time

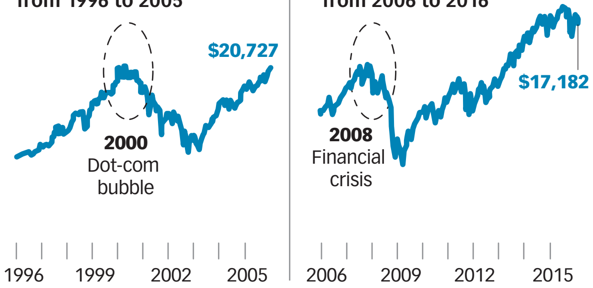

Chart 2: The performance range of global equities over different time frames

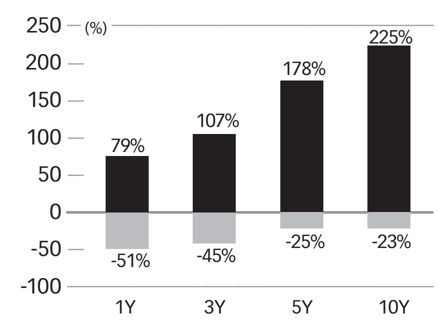

Chart 3: Global equities trade cheaper during economic crises

Sources: HSBC, Bloomberg

How to invest during a market downturn?

Take advantage of the situation – market downturns may create opportunities. Don't be passive in the face of market declines. When market sentiment is low, valuations tend to be driven down which provides investment opportunities (Chart 3). In rising markets, investors tend to invest as they chase for returns, while in declining markets they tend to sell. When investors overreact to market conditions, they may miss out some of the best-performing days. The time when "everyone" is overwhelmingly negative often turns out to be the best time to get into the game.

Is there an all-weather investment vehicle?

If there is one "all-weather" strategy, it is to stay diversified. Different asset classes often perform differently under various market conditions. By combining assets with different characteristics, the risks and performance of different investments are combined, thus lowering overall portfolio risk. That means a lower return in one type of asset may be compensated by a gain in another.

The other discipline is to invest regularly, despite market volatility. When investors make regular fixed investments, they buy more units when prices are low and less when prices are high. This will smoothen out the investment journey and average out the price at which units are bought. It thus reduces the risk of investing a lump sum at the wrong time, particularly amid market volatility. The longer the time frame for investment the better, because it allows more time for investments to grow (the compounding effect).

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