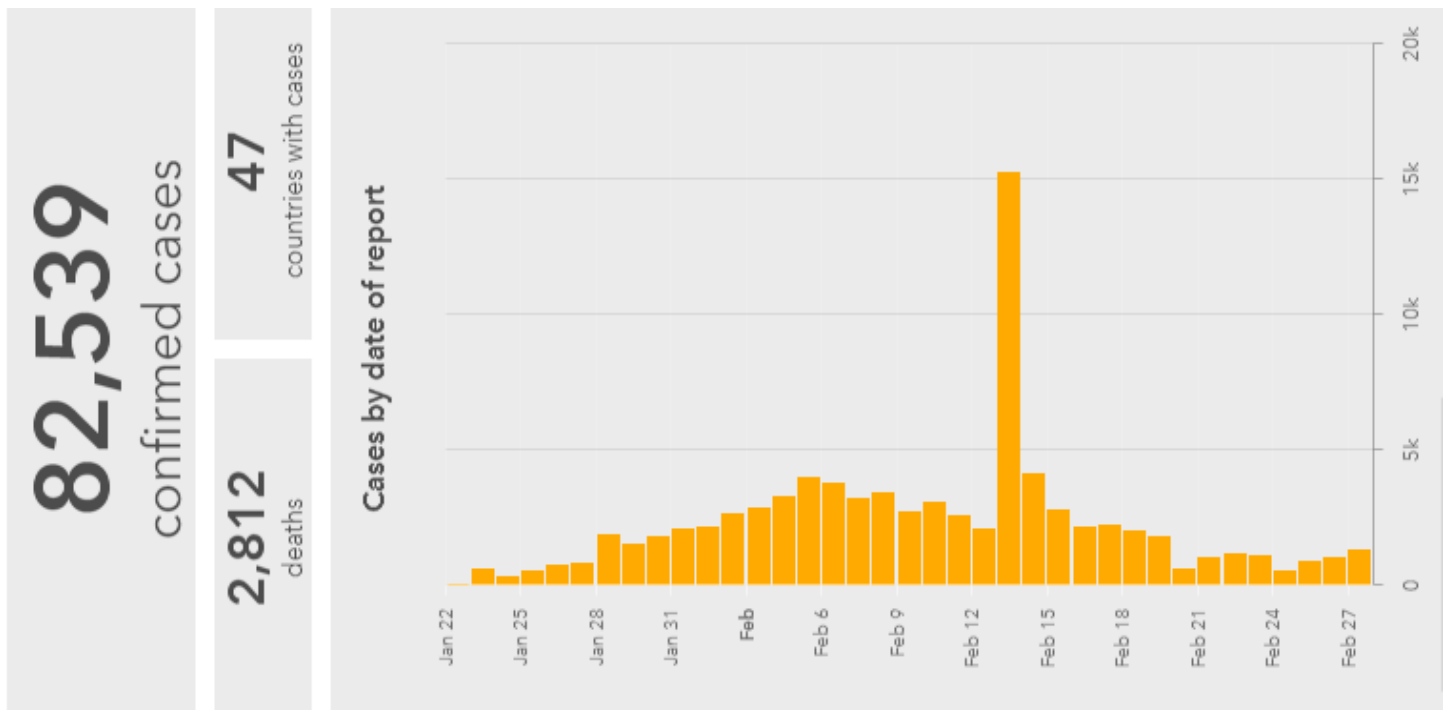




Coronavirus (COVID-19) - Investment decisions in times of stress

With Coronavirus causing turmoil in investment markets globally we have seen significant market moves across asset classes over the past week. With such an event it is extremely difficult to estimate investment outcomes, however one trait is reasonably certain: our human bias for loss aversion, which is heightened when fear like this spreads. This fear is exacerbated by news flow – real or fake – and quite often the real potential impacts of such an event are not fully considered outside of the gut reaction of blind panic. At times like these it does pay to pause and consider the real-world outcomes for investors, and how we should consider investment decisions.

The chart below indicates the frequency of new COVID-19 cases since 22 January 2020^[1]. Of the 82,539 cases reported thus far, 78,630 originated in China – and interestingly it shows that the frequency of new cases has slowed since mid-February with the WHO^[2] indicating that the virus “peaked and plateaued between 23rd January and the 2nd February”. The death rate thus far is 3.4% of all reported cases. This compares against the Ebola virus where the 2014-2016 outbreak in central Africa affected approximately 30,000 people with a 40% fatality rate, and SARS (2003, 8000 cases with a 10% fatality rate).



Source: World Health Organization

More recently we have seen new cases across Korea, Italy, Iran and Japan which has added to market anxiety, fearing a global pandemic. Most governments have issued varied warnings particularly relating to travel.



What has hit investment markets however are the multitude of warnings issued by companies indicating that their ability to operate and trade is being severely impeded. In the current investment environment where company earnings have been quite strong, this news has not been well received and share prices have fallen as a consequence, while safe haven investment grade bonds have rallied as investors seek shelter. Chinese businesses are a key part of the global supply chain, and as a result it is broadly expected there will be a global economic slowdown as businesses struggle to get supplies from China. Since their peaks around mid-February, share markets have fallen 10-11% to date.

From an investment perspective we are faced with a few choices:

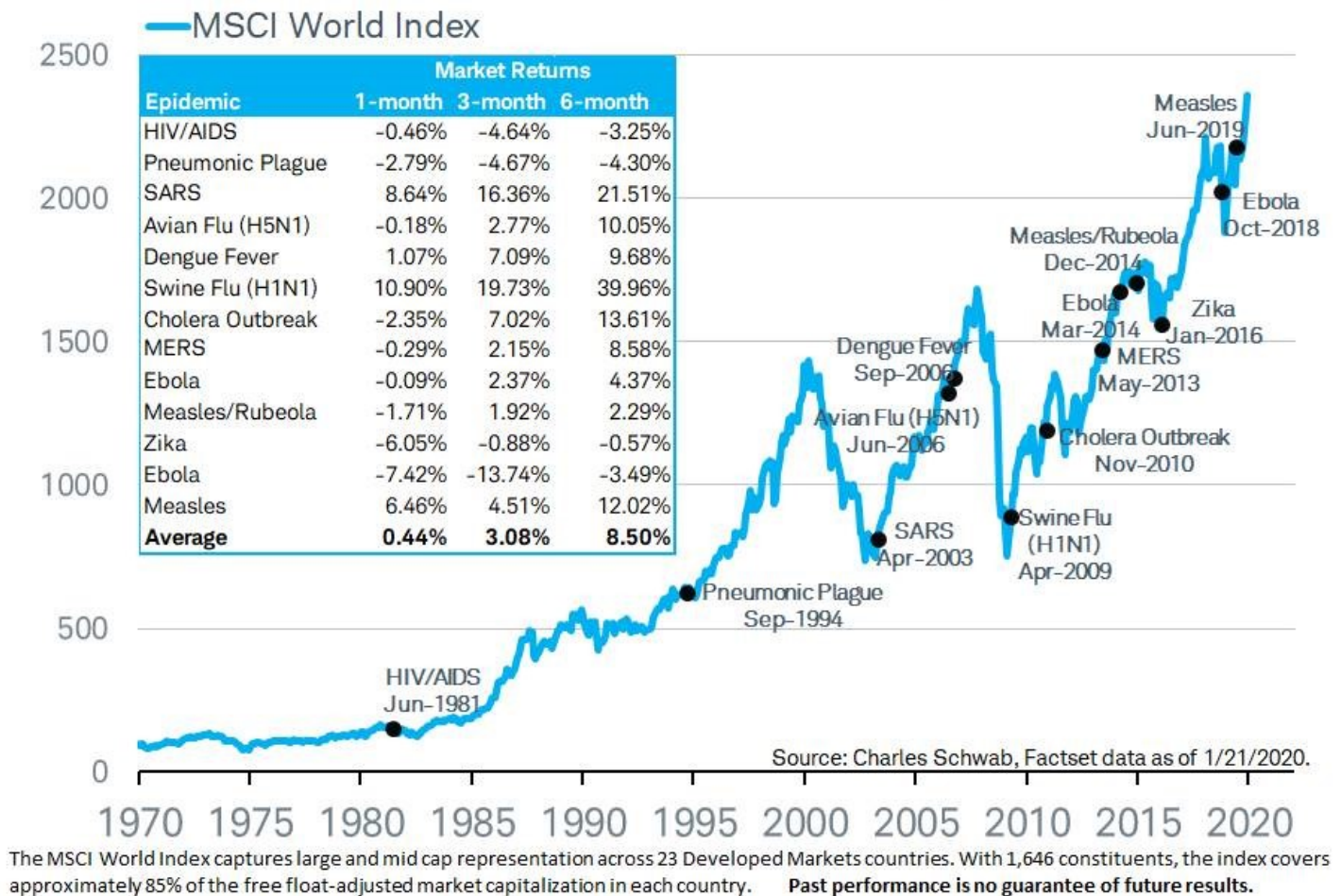
- React to the loss aversion bias and de-risk, selling equities where you expect markets to fall materially further. This is a particularly hard trade to get right for a few reasons. Firstly, the frequency of bad news not turning into bad equity returns is actually quite high (we often get anxious for no reason). Recent examples include the China growth panic where global equities fell 13% in the first 6 weeks of 2016, and subsequently delivered returns of 54%. In Q4 2018 trade war anxiety and global growth concerns drove an 18% fall in equity markets, which was followed by a 35% positive gain. At the time the bad news is happening, it is very difficult to see good returns in the near future, however this has often been the case. De-risking after a sell-off as we have seen can result in permanent losses. The second reason is that it is very hard to time the re-entry, particularly when fear is driving markets, and often investors will wait too long and miss a significant part of a recovery. So, they catch a fairly large part of the initial loss, de-risk, and then fail to capture the recovery. All in all, this is a relatively low success trade.
- The opposite approach is to act on fact. This would mean biding your time and watching for opportunities to add to equity allocations as you see prices fall (noting that this is much harder to do! It is much easier to sell into weakness given the behavioural conflicts at the time). In the case where equities have fallen, you can see the lower prices and you can make a 'value for money' based decision. In many cases, the opportunity to 'buy cheap' is a significant source of wealth creation. Compared with option 1 above, there is no need to guess or forecast what markets will do, as you can observe the prices in real time. This is a higher odds trade.

There are instances where de-risking is justified: cases include the Tech Bubble (1999/2000) and the GFC (2008/2009). In both instances, equity markets were significantly overheated and drove their own demise. Currently – the US is relatively expensive by most measures, so it should be no surprise that the S&P 500 and Nasdaq have lead declines.



The chart below highlights how equity markets can be surprisingly resilient in the face of global fears

Immune: world epidemics and global stock market performance



Source: Charles Schwab

One of the key aspects to consider is whether the impact of COVID-19 will have temporary or permanent effects on asset prices. A temporary example would be where a manufacturer (e.g. Tesla) must delay vehicle production by 6 weeks given problems with their supply or restrictions on staff as containment of the virus takes place. Does this mean Tesla should be worth materially less, if its production is delayed 6 weeks? The share has fallen 25% in the past week, so it is clear what the market thinks, but is it rational?

There are scenarios where the impact of the virus could be permanent though. Take for example a protracted economic slowdown which is now seen as a natural extension of a temporary economic slowdown. Can companies with high debt levels service their repayments if they are operating 20 or 30% below normal sales levels as a result of the outbreak? Are we at risk of the global debt bubble unwinding as a result? These disaster cases have merit if there are conditions which warrant it (in this case high corporate debt levels).



The questions we can ask as investors include:

- Am I invested in a suitable investment given my needs and risk profile? Equity markets are by nature volatile, and this is a normal part of the journey. Do I understand the risks?
- Do I understand the timeframe over which my investment needs to be held? Higher return portfolios require longer investment horizons, often 10 years or longer. Lower return portfolios are more resilient to these risks.
- Am I needing income or capital from my investments, and would drawing out now prejudice my savings plan? Drawing from a risky portfolio when markets are volatile exposes investors to weak markets having a permanent impact.
- If I am planning on investing new money, should I wait? Often with volatile markets it does pay to wait, but it also makes sense to get started. Equities are over 10% cheaper than they were a week ago. They're on sale so this should be a positive indicator, rather than a negative one. Phasing in is often a good start in cases like this, rather than trying to time the bottom.

From a portfolio management perspective, we follow these principles:

- Make sure we're not overexposed to overpriced riskier assets to start with, which could permanently impair returns in a drawdown. This allows us to ride through the volatility, in line with the risk parameters of the portfolio. While this may work against our loss aversion bias, it is also a more rational approach given the potential range of outcomes possible, both good and bad. These positions need to be in place at all times, and should precede any one-off risk event like COVID-19.
- Ensure we employ strong fund managers who can make rational decisions when markets are weak, and to take advantage of the opportunity for recovery when they present themselves.
- Diversify the manager selection, so that we are not overexposed to single decision maker errors which is heightened at times of stress.

Overall, provided investors are suitably invested, most often the right action to take is to do nothing. Financial plans provide for the fact that market events like this can and will happen. Volatility is never pleasant, but it does serve as a useful reminder around both the embedded risk in what it takes to get investment returns, as well as the importance of ensuring your financial plan is in place.

^[1] The spike on 13 February 2020 was due to a retrospective change in how cases were reported and does not reflect new cases on that day, but rather the cumulative cases preceding that day.

^[2] World Health Organisation