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CHARTERED FINANCIAL PLANNERS

SKERRITTS VIEW - NOVEMBER 2018

Up The Stairs…Then Out Of The Window:

What is it about October? October 1929 – crash; October 1987 – crash; October 1998 – crash; end of September/early October 2008 – crash; October 2018 – correction…or at least we think it is. Whatever you want to call it, it is very unpleasant but, much like a Halloween trick or treater, however unwelcome it's not totally unexpected.

The 2018 correction is a bad one as far as recent history is concerned, but it is significant in other ways. It is a classic example of markets climbing the stairs, then falling out of the window. For most investors they have come to accept that this is normal market behaviour, but this time they are being made more aware of the short term pain that this can cause. It is the first such correction to happen since MIFID II, which means that it is the first one to have led to 10% letters being sent to clients informing them that some of their portfolios have declined by 10% since their last **quarterly** valuation.

You don't need a degree in behavioural finance to know that the pain caused by financial loss is greater than the satisfaction caused by gain. This is because one tends to happen far more quickly than the other. Capital gains tend to happen gradually, and it's very rare for markets to melt up as fast as they can melt down. On the other hand, as we've just seen, "paper" losses can happen very quickly and are alarming for anyone experiencing them. Hence, the climbing the stairs and falling out of the window analogy. But they should remain just that – paper losses – unless investors panic and sell at the wrong time.

The introduction of the 10% rule, coupled with statements being issued every three months instead of the previous six, is going to encourage the very short term thinking that generations of advisers have tried to counter. Indeed, we are still told that investments are for the medium to long term. Why, then, highlight anything bad in the short term?

Investing For The Longer Term Has Just Got More Difficult:

We appear to be moving into the next phase of this particular bull run. For some, the jury is out whether we've actually entered a bear market now, but we maintain what we have set as our "line in the sand" when it comes to peak cycles, which is that over the years it has been virtually unknown for a bull to phase into a bear if the next recession is more than twelve months away. We could not say with any certainty that this is not the case in the UK, which is why we don't invest in the UK, but in the case of the US it appears a remote chance that the next recession is that close. Which means that markets have a new peak to attain first.

BUT….the easy money has been made. We've most likely entered a phase transition whereby optimism is losing its hold over pessimism, and this will undoubtedly lead to more short term volatility. We've been through a strange era where bad news has actually been seen as good news, because the reaction to the bad news was centrally generated stimulus. Good news was rewarded

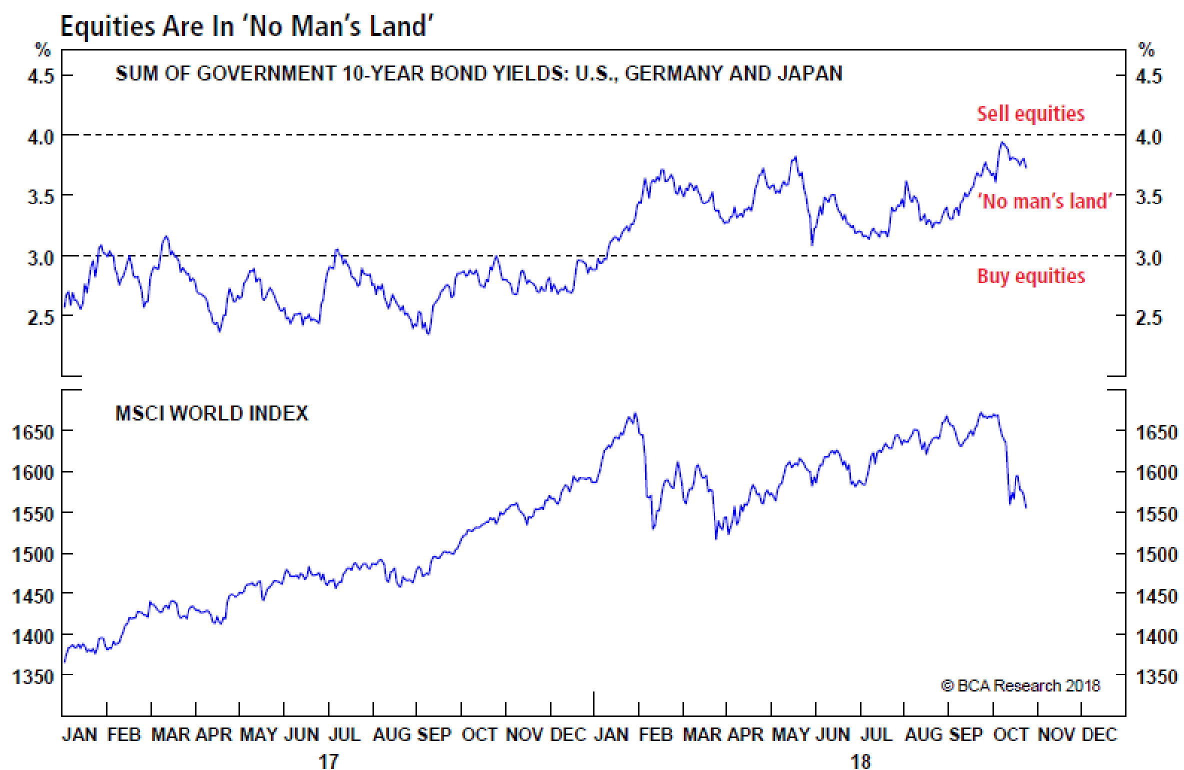
on the back of this. Now though, bad news will be seen as what it is and prices will react accordingly because the days of stimulus are most likely at an end (unless a crisis kick starts it again). On the other hand, good news such as high levels of employment will be seen as bad news because central banks will be forced to tighten. You will never hear central banks admitting to bringing on a recession, but by raising interest rates to prevent an economy from overheating, this is exactly what they are doing.

A phase transition in science occurs when a substance changes from a solid, liquid or gas into a different state. Think of water turning to ice or steam at given temperatures. There is a wide range of temperatures between the trigger points which are hard to identify just by looking at them. Once the tipping point is reached, the shape of that substance changes dramatically. So it is with markets. Change can be bubbling up without any real outward signs, but once the tipping point is reached things go haywire. We've just had a haywire moment. Eventually, it settles back to its natural state once more.

So with more volatility, quarterly statements, 10% letters and media scrutiny, a fund manager's long term horizon has probably shrunk from, say, five years to around 9 months or less as far as their investors are concerned, because any period of underperformance could result in the investor moving on to seek riches elsewhere. This can't be the basis for the best outcomes, but only hindsight tends to change policy. Sadly, there is no such thing as the Hindsight Fund.

In The Absence Of Hindsight……:

So, in the absence of hindsight, let's try some foresight. What are we looking for as our trigger points?



This chart is one of those that proves that a picture can be far more powerful than words. What this chart is showing us is the relationship between bond yields and equity performance. Using research published by BCA, as fund managers we are keeping an eye on the sum of the 10 Year Treasury Yield, the German Bund and the JGB (Japanese Government Bonds). Should this breach the 4% level, we would seriously consider going into full bear mode in our fund construction, but as the chart indicates, we've had two spells this year now where the aggregate bond yield has crept up, triggering an equity sell-off. As the equities sell-off, so the bond yield retreats, allowing recovery to take place once more in the equity markets. What this leads to, though, is a prolonged "sideways" movement which will continue until the upper or lower bounds are breached.

This is why we actively manage our funds on a tactical basis to try to take advantage of these interim movements. At the moment we are cash heavy, awaiting the opportunity to step back into our chosen assets to, hopefully, buy the same investments that were attractive a few weeks previously, but at cheaper levels than we sold them. Of course, the bulk of our funds remain intact as to time markets correctly on a regular basis is an expensive and virtually impossible feat to achieve. So, we sit and hold our favoured sectors and trade tactically with the balance. This way we hope to successfully navigate the market waters turning into steam or ice, without getting burnt or frozen too badly in the process.

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