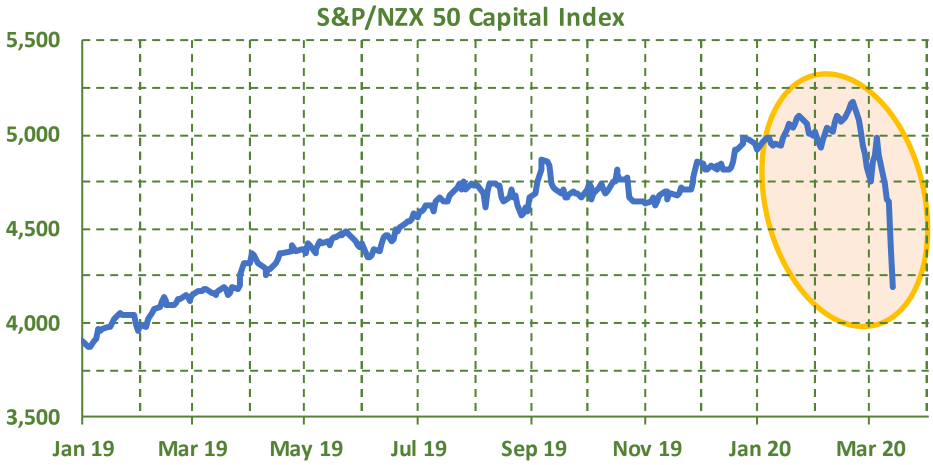
Reacting to COVID-19 induced market movements

- a general discussion

March 2020

In recent days, there has been a significant sell off in the share markets around the world. This is illustrated by the fall in the New Zealand market, as indicated by the S&P/NZX 50 Index to 13 March 2020.



Source: S&P/NZX 50 Capital Index

The fall, from the peak on 21 February 2020 has given back the gains achieved over the last year. But still, at close of the market on Friday 13 March, the return since 1 January 2019 has been 5.9% a year (7.1% for the 14.5-month period). This is the market movement return. In addition, investors have received dividends. The gross return including dividends has been 10.50% a year. The return after imputation credits, ie to a non-taxpayer, has been 9.49% a year. These returns, despite the dramatic falls since 21 February 2020, remain above the long-term average and that expected on average over the next 20 years. Investors should therefore be accepting of the fall, but it is still a 19.1% fall since 21 February 2020.

In response to the fall, the number of articles written providing commentary and making suggestions of what to do, has increased. This article is simply one of the many. The main messages are typically, "don't panic", "have patience" and "sit it out". The important question however, is "do you have the right investment strategy and policies, for your cash flow liabilities and risk temperament?"

But first note:

- No one knows the full extent of the virus and how bad the impact will be and when it will be under control, and

- No one knows what will happen to the investment markets in terms of how far they will go down and how long it will be before they fully recover. The immediate impact is not that capital has been destroyed, like in the GFC (global financial crisis) but that a company's revenue and therefore profits will be materially down, over the immediate future and for an unknown period. Yes, companies with poor balance sheets may not survive and this will permanently destroy capital.

There are two aspects to a market downturn. The first reflects the present value of the reduced profits of businesses, particularly in the travel, tourism and event sectors, and the flow on of this to downstream businesses. The second reflects human emotion and reaction to the reduced profits and market downturn. We must remember that market movements reflect the outcome of the collective rational and emotional responses of investors, reflecting the personalities of the individual investors. This is a balance of the decisions at the marginal investor level, as most people will choose to do nothing or will do nothing because they do not make decisions.

The basic premise is that, if more people want to sell shares than buy shares, the markets go down. As the reaction of many people will be to sell, there is likely to be downward pressure on the markets for the immediate future. Therefore, to guess when the markets will recover, requires a guess about when the majority of investors at the margin stop selling and either hold or start buying. This will depend on when they have confidence that the uncertainty around the economic and financial implications of the virus will not stop them achieving their financial goals.

No matter what the investment theory suggests people do, there will always be some investors who want to sell, and get out of the markets, when an event like COVID-19 occurs. The question is, do you want to crystallise the current losses which are expected to be only temporary, perhaps 1 to 2 years, or do you choose to let your current policies play out? A lot will depend on whether you can meet your expenditure in the immediate future and how you feel about the losses and about doing nothing.

So, what should investors do in response to the market downturn?

Investors will fall into one of two broad groups. Those who on 21 February 2020 had the right investment strategy and policies for their liabilities, goals and temperament, and those that did not.

For those that had the ***right strategy and policies***, no action is required. The strategy and policies would have been set up to cope with the inevitable downturns. The downturn, since 21 February 2020, is just one of the many downturns that will occur over the next 25 years. Over the next 25 years (the average time of a person retiring at age 65 will have in retirement), there is likely to be 8 or 9 elections, 5 or 6 change in governments, 2 to 3 recessions, 1 to 2 viruses, which we currently do not know the names of, and 1 to 2 earthquakes. These are just a few of the many things that will occur and may potentially lead to share markets declining 20% or more. This is the way that the financial markets work and what the investment strategy and policies have to be designed to cope with.

The important issue is whether the investor will still achieve their true goals. Such goals normally relate to the need for a growing stream of income to meet expenditure, as opposed to achieving a particular level of assets. Most investors, and their advisers, however, often think in terms of asset levels and returns in isolation to the cash flow liabilities.

If the investor, had the ***wrong investment strategy and policies***, the question is “how and when do you move to the right investment strategy and policies?” Given that the NZ share assets are now 19.1% lower than the level at the peak, “do you do it straight away, or when the markets have recovered?” The conventional view is to wait until the markets have recovered, or to do it in several steps. The better view is to do it when you feel most comfortable, as you must live with the consequences. Doing it before the market recovers, means that you lock in the losses. Doing it after the market recovers may mean that you have several sleepless nights in the meantime. While no one knows when the markets will recover, the “experts” all expect that the markets will recover in time and what is now a temporary loss will be reversed. Your temperament will determine whether you should act now or wait and then act.

The key goal has to be to get the investment strategy and goals correct for your liabilities and temperament, so that when the next market downturn happens, as it will, you are not faced with the same dilemma.

Investment policies

The purpose of an investor’s investment strategy and policies should be to align the cash flows from the investments, with the cash flows of the liabilities. The cash flows from the investments flow from the interest, coupons, net rent, cash dividends, distributions from products, maturity proceeds from bonds etc.

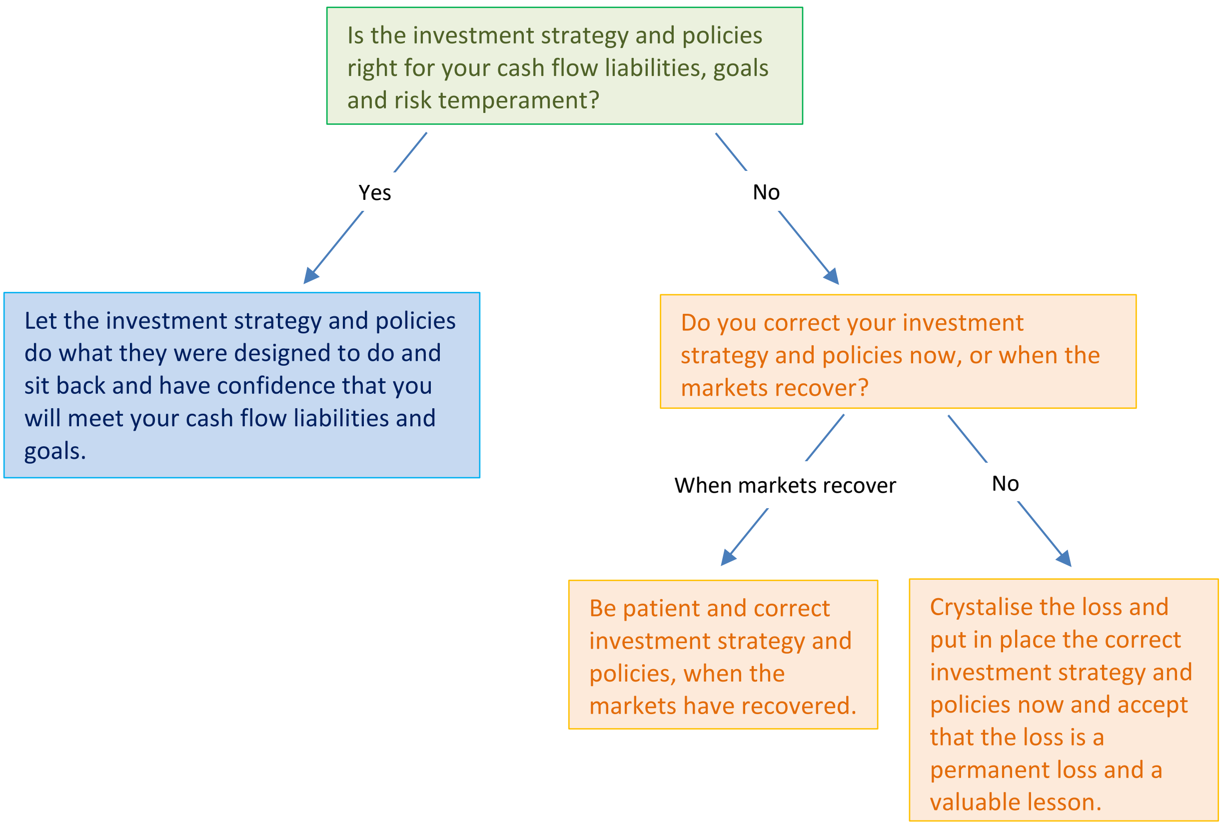
The cash flows of the liabilities are the expenditures that will be met from the investments. This might be the living expenses in retirement for an individual, or the grants and management expenses of a charity.

If the cash flows align, the investor should have confidence that they will not be financially embarrased when the markets decline. If they are not aligned, the investor is taking on the risk of being forced to sell an asset to meet a shortfall. If you will be forced to sell to meet the cash flow liabilities, it is better to have cash assets so that they can always be sold without incurring a loss.

The important question therefore is “if the investment markets went down today, eg by 10%, 20% or 50%, will you still be able to meet your cash flow liabilities?” And, are you confident that you will still be able to meet the liability cash flows? If the answers are yes and yes, the next question is “But, would we panic and sell, thereby crystalising the temporary loss as a permanent loss, and as a result not be able to achieve the liabilities because of the reduced capital?”

The investment policies may be wrong because they do not generate sufficient cash flow at the times it is needed, or because there is not sufficient cash to supplement the natural income return and you are forced to sell an asset, or because your temperament does not react positively to the market fluctuations. There is no single investment strategy and policies that is right for every investor, because they may each have different cash flow liabilities and will have different risk temperaments. Being able to sleep at night is important.

Decision framework



For further reading, check out the articles on the MCA website “**Keeping investing simple**” and “**The bucket approach to investing**”.