Market Reaction Commentary

09 March 2020

What has happened?

This morning, global markets have seen some of their biggest moves in recent history, with the FTSE down 8% at the time of writing, and this on the back of two weeks of equity market weakness. There are some very significant issues of concern for investors; the Coronavirus is evolving into a pandemic the likes of which investors have never had to deal with before. Comparisons have been made to the 2002-2003 SARS outbreak and the Spanish Influenza. However, the reality is that SARS was not as widespread, neither geographically nor in terms of the number of infections. The Spanish Flu of 1918-1920, whilst severe in terms of its outbreak, occurred 100 years ago when financial markets were not as inter-connected so comparisons in terms of stock market reactions are not particularly meaningful.

The movement into uncharted territories creates significant uncertainty for investors in terms of how to model and analyse asset prices. Markets initially brushed off the threats posed by the Coronavirus, but now its effects are starting to leak into our daily lives as we begin to observe its consequences first-hand. Consumers are panic-buying food and essentials, employees are self-isolating and working from home, trading houses are splitting themselves up geographically as a precautionary measure.

Markets have been grappling with the Coronavirus for weeks now; why have we seen equity prices react so dramatically today?

Today saw oil prices crash by around 30% in the start of a price war between Russia and Saudi Arabia. The largest exporter of oil, Saudi Arabia, slashed prices at the weekend after failing to convince Russia to participate in drastic production cuts. This sent the price of Brent Crude tumbling to $36 a barrel and on course for its largest one-day fall since the 1991 Gulf Crisis. This in turn has led to enormous stress on US companies in the shale fracking and energy industries. Alongside the continued pressure of Coronavirus, this confluence of bad news has spooked investors and markets have pulled back accordingly.

Many companies globally are operating with significant debt on their balance sheets. As the virus continues to accelerate, revenues and cash flows are being meaningfully impacted and investors are coming to grips with the potential ramifications. The ability of some firms to service debt payments in addition to paying fixed costs like rent and staff wages is compromised when revenues falls. Investors are analysing and reassessing the impact on growth, appropriate valuations, and the impact on corporate balance sheets.

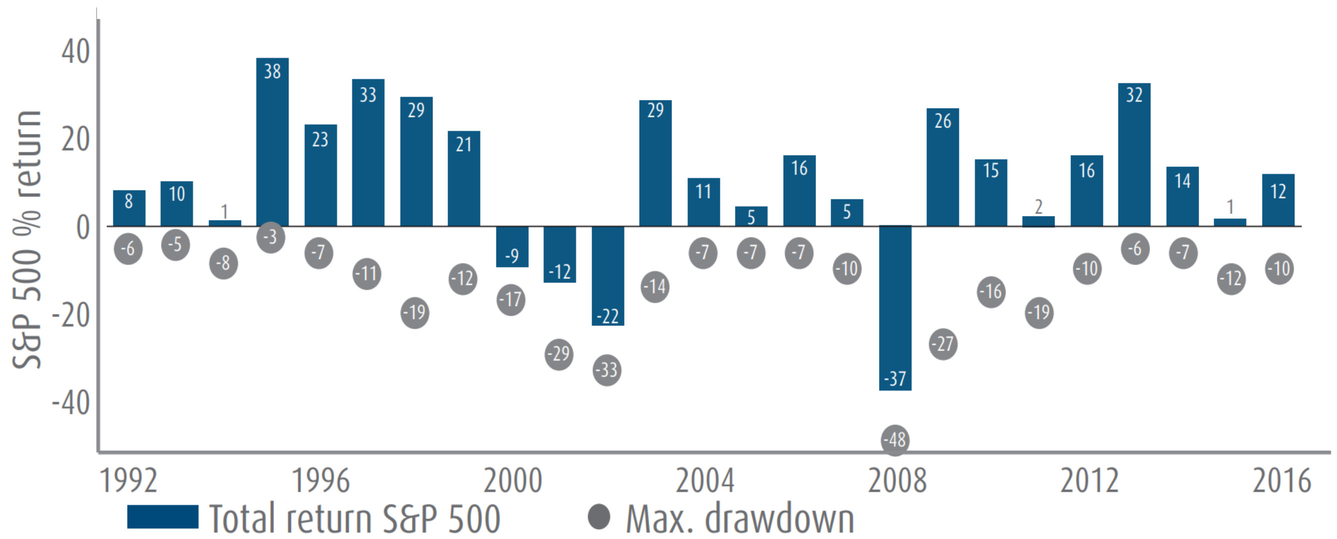
How bad is the situation?

This outlook and the drop in equity prices might look bleak, but panic-based decision-making is a recipe for disaster. For long-term investors, current market conditions will almost certainly be remembered as a blip in ten years' time. While such market pull backs seem intense at the time any glance at long term equity charts show such panics as temporary blips that should have been used as buying opportunities. Ultimately, some companies experience extreme financial stress during recessions and bankruptcy is possible for those with weaker balance sheets and those whose revenue streams are most vulnerable. However, when the dust settles, diversified portfolios recover and move to compound to new highs. Investors who own companies with solid balance sheets which can weather these storms do very well over the long term.

After weeks of complacency, markets are now panicking. However, the strong likelihood is that much of this panic is already priced in. Selling now might protect against a small further fall in prices, but the possibility of not buying back in becomes the real risk. Selling out of markets now might bring short-term comfort, but in the long term, failing to buy back in or market mistiming will do severe damage to the ability to generate wealth. In fact, selling now makes it highly probable that re-entry occurs at higher prices, eroding value in so doing. As valuations become more attractive, good quality assets get significantly cheaper. Selling at the bottom is the worst mistake an investor can make when markets drop this dramatically. The graphic below illustrates how investors can still experience positive returns in a calendar year, despite experiencing significant short term losses (peak to trough 'drawdown') within that year, so long as they don't crystallise their losses.

As complacency evaporated from the market and the situation developed last week, we sold down some equity exposure in the lower risk portfolios and redeployed this capital within our holdings in gold, absolute return and cash. We also continue to review all of our individual equity holdings. As such, we sold out of a stock which has sensitivity to the travel industry and higher levels of leverage than we were comfortable with. We continue to be diligent in the analysis of our portfolios and are spending time evaluating the risks to all of our positions, but equally we are looking ahead and preparing for markets to stabilise when the appropriate course of action will be to buy not sell.

Total return by calendar year and intra-year max drawdown



Source: BMO. Past performance is no guarantee of future results.

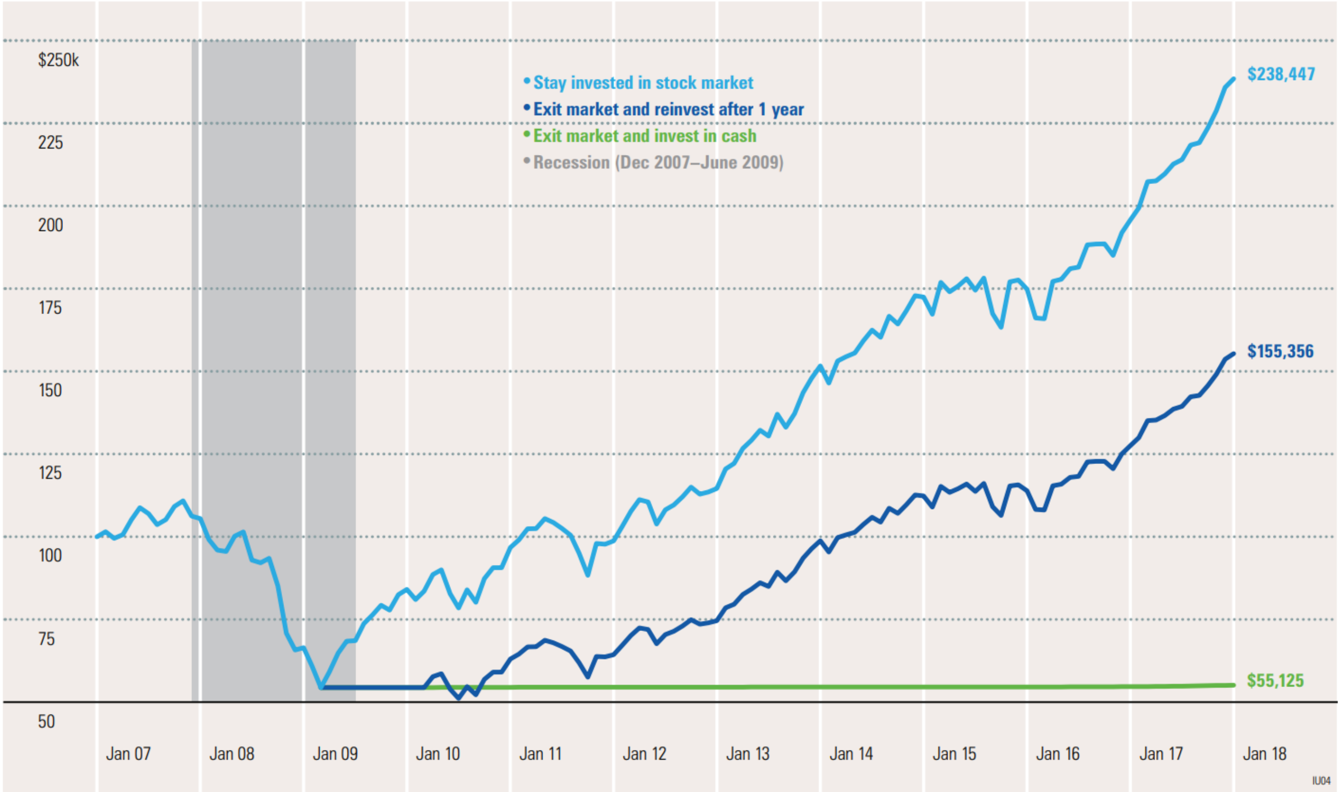
What are we doing about it?

We spent a considerable amount of time in January and February analysing and quantifying our portfolio exposures to the Coronavirus. As a result of this analysis, we took targeted steps in our direct funds and models to reduce the cyclicality and increase the protection against equity market weakness. For example we sold Samsung, a cyclical company exposed to Asia, in mid-January in order to buy Heineken, a more defensive and diversified company. In February, we initiated an unhedged position in US Treasury bonds, designed to benefit from US dollar strength and potential rate cuts in the US as a likely response to stress in the global economy caused by the Coronavirus.

What is our overriding message?

It is crucial at times like these to remember that we are long-term investors. Time in the market is the greatest defence against extreme periods of volatility but that defence is significantly weakened if investors fall into the trap of panic-based decision-making. Selling at the bottom of the market erodes the value of a portfolio given the reasonable likelihood that current market conditions will appear temporary in the fullness of time. We are continuously searching for high-quality businesses which have been unfairly treated in the sell-off. These opportunities can allow us to pick up strong companies at very attractive prices whilst less disciplined investors continue to engage in panic-induced disposals.

The graph below demonstrates the importance of staying invested, showing the ending wealth values after a market decline. In the aftermath of the financial crisis, an investor who held their position throughout ended up with a portfolio value ~50% greater than if they had decided to sell out of the market at its lowest point and bought back in one year later.



Source: Morningstar. Past performance is no guarantee of future results. This is for illustrative purposes only and represents the value of $100k invested in the S&P 500 Index over the timescale shown.

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