WEATHERING THE STORM

The case for sticking with equities

Robin Powell
Consultant, Educational Content

Published: 11/04/2023

It may seem strange, but it's a fact, backed by academic research, that most of us would achieve better investment returns if we simply traded less often. We would probably do even better if we didn't trade at all.

Of course, we need to get invested in the first place, and, ideally, automate our ongoing investments so the money goes out of our bank account without our having to do anything. But the point is, we can achieve great things as investors by doing precisely nothing.

Fidelity once conducted an internal review of customer performance. What it revealed was that two groups had distinctly better returns than any other. The second best returns were achieved by customers who didn't trade (and had probably forgotten they had accounts at all), and the best returns of all were achieved by those who were dead.

The behavioural scientist and Nobel laureate Richard Thaler once posited that the ideal investor would be Rip Van Winkle. "Rip could invest in the market before his nap," said Thaler, "and when he woke up 20 years later, he'd be happy. He would have been asleep through all the ups and downs in between." And that, essentially, is the problem. You can't just invest all your money in equities and go to sleep until 2043; you actually have to live through all manner of scary news stories between now and then.

Markets have proved remarkably resilient

Just imagine you were born in 1900 and given a globally diversified equity portfolio that you weren't allowed to touch until retirement. You would have lived through the First World War, the Spanish flu, the crash of 1929, recession in the 1930s, the Second World War, the atom bomb, the Cold War and the Cuban Missile Crisis; and yet, despite all those events, you would still have enjoyed remarkably healthy investment returns.

The point is, bad things happen and they always will. There will always be reasons to be fearful about your investment portfolio. But markets, historically, have shown an extraordinary degree of resilience. If you can just hold your nerve and stay invested, then history suggests you should be all right in the end.

The question for investors today is this: Are the threats to the global economy and the financial markets so exceptional in 2023 that you should reduce your exposure to equities? There are certainly quite a few such threats around — war in Ukraine, for example, tensions with Russia and China, and, of course, climate change.

Risk works one of two ways

All three of those situations are very complex, and different experts expect them to play out in very different ways. There is, of course, a risk that all three will end badly, in which case the potential hit to equity prices could be huge. But a point we sometimes forget is that risk works one of two ways. Sometimes it's the downside risk that prevails, but sometimes it's the upside. It's perfectly conceivable, for instance, that the war in Ukraine may end sooner than expected; global diplomatic tensions may begin to ease; and, as carbon capture technology improves, we may be able to reverse (or at least slow) the rate of global warming.

It's human nature for us to focus on worst-case scenarios. That's how we've evolved as a species to handle the different threats we've faced over tens of thousands of years. But evolutionary instincts rarely serve us well as investors.

> It's human nature for us to focus on worst-case scenarios. But risk works one of two ways. Sometimes it's the downside risk that prevails, but sometimes it's the upside.

You might be thinking: But what about the gloomy economic outlook? Is it really wise to invest in equities when things are so uncertain? Again, if you look for it, you'll find plenty of evidence that appears to support that argument. The Federal Reserve in the US, as well as other central banks such as the Bank of England and the ECB, have raised interest rates to counteract strong inflationary pressures in their respective economies. This is bound to dampen growth, and there are concerns that it could also lead to recession.

Economic forecasting is, however, notoriously hit-and-miss, and the tendency is for economists to err on the side of pessimism. As Katie Martin, the FT's Markets Editor, wrote the other day, no one wants to be the Michael Fish of market predictions (you may need to Google "great storm 1987" if you don't know what she means). Or, as the Nobel Prize-winning economist Paul Samuelson once joked, "Economists have predicted nine of the last five recessions."

Is this 2008 all over again?

Ah, you might say, but what about the current banking crisis? What if that escalates, as happened in 2008, into a full-blown market meltdown? The answer of course is that it might. But is it likely to result in a situation similar to the global financial crisis (GFC)? On the balance of probability, no, it isn't.

The GFC and the current crisis are very different. The GFC was a systemic crisis that affected the entire financial sector. Banks and other financial institutions were heavily exposed to poor quality mortgage securities and other assets with high credit risk, and suffered significant erosion of their balance sheet when those securities were marked down in price.

The event that triggered the market crash in September 2008 was the collapse of Lehman Brothers, a systemically important bank. That caused widespread panic among other major institutions as they struggled to assess their balance sheets and counterparty exposures.

Hugely painful though it was, the GFC had some positive consequences. Banking regulation was stepped up globally and capital buffers were raised, to help prevent future bank failures. Also, efforts were made to increase transparency in derivatives markets to make it easier to assess the exposures of financial institutions. Both of those developments make a recurrence of 2008 much less likely.

SVB bears little resemblance to Lehman Brothers

What's more, the issues facing the banks that have been in the headlines in recent weeks are nothing like those that brought down Lehman Brothers.

Silicon Valley Bank, for example, faced a duration mismatch between its assets and liabilities, and lost money on its holdings of long-term bonds as interest rates rose. When clients withdrew funds, SVB faced a shortfall. Although this is a fairly elementary failure of risk management, it isn't evidence of systemic failure.

As for Credit Suisse, that had been widely regarded as having difficulties in its core business for some time. For example, it recently suffered significant losses due to its exposure to both Greensill and Archegos. It has also suffered a high turnover in its senior management.

So are we seeing a repeat of 2008? Media commentators and people in the City are certainly asking the question. But, to quote Katie Martin again: "Every single

Silicon Valley Bank, faced a duration mismatch between its assets and liabilities and although this is a fairly elementary failure of risk management, it isn't evidence of systemic failure.

professional investor I've spoken to over the past two weeks has said 'no', and for what it's worth, I agree with them."

Markets reward the calm and rational

Just to clarify, I'm not saying here that Katie Martin and her contacts are right. Nor am I saying that I don't expect a long-drawn-out recession. I'm simply saying, I don't know. What I do know, however, is that fear and loss aversion are very powerful motivators, and the key to successful investing is to keep our emotions and biases in check. Over time, markets tend to reward patient investors who stay calm and rational.

Market timing is seductively appealing in theory; but it's devilishly hard to get it right in practice.

What, then, should investors do now? The logical response, in most cases, is nothing at all.

There are two key reasons why I say that. First, nobody has a crystal ball. Nobody knows how this latest banking crisis will develop. And nobody knows whether or not we're entering a global recession. And, if we are heading for recession, predicting how long it will last and what impact it will have on the financial markets is extremely hard.

Yes, you could take risk off the table now, just in case the worst happens. But what if it doesn't? You could miss out on significant market gains. And even if you're right, and the markets do fall sharply, you still have to time your re-entry. Market timing is seductively appealing in theory; but it's devilishly hard to get it right in practice.

Current prices reflect all known risks

The second reason why sitting tight is the logical response to stock market turbulence is that all known risks are already factored into prices. In other words, current prices already reflect the possibility, say, that more banks will collapse, that we're entering a long and deep recession, that Putin will use nuclear weapons in Ukraine, or that China will invade Taiwan.

Markets are like a giant super-computer. Prices are constantly adjusting. They respond, within seconds, to new information, whether good or bad.

Markets are like a giant super-computer. Prices are constantly adjusting. They respond, within seconds, to new information, whether good or bad. If you decide the outlook is now so bleak that you want to reduce your equity exposure, then you're going against the aggregated knowledge and wisdom of the entire market. You may, of course, be right, but given how much it could cost you if you're wrong, it would be a very brave call to make.

Of course, when I suggest doing nothing at all, I'm assuming you already have an investment strategy in place that you're totally happy with. If you don't, there is no time like the present to put that right.

You should choose a portfolio of assets that broadly balances your desire for growth with your unique capacity for risk. Equity investing is inherently risky, and you shouldn't take on more risk than you need to take, can afford to take, or feel comfortable taking. History tells us that the market will test investors' tolerance of risk, which is why you should ideally work with a financial planner who knows how to measure your risk tolerance accurately, and can spot if it ever needs any adjustment.

But history also tells us that successful long-term investing involves riding out periods of turbulence, and that it pays to stay invested when risk aversion in general is high. We're going through just such a period now.

Think back to January 2020

If you're still not convinced that sitting tight is the right course of action, then cast your mind back to the start of 2020. Say you did have a crystal ball. Suppose you knew, in advance, that we were about to see a global pandemic that would shut down much of the world's economy. Say you knew as well that the seeds were being sown for the biggest land war in Europe since 1945, and that inflation would rise to levels not seen for decades.

Over time, markets tend to reward patient investors who stay calm and rational.

Armed with that information, most investors would want to get out of the stock market, and stay out indefinitely. But what actually happened in practice? The S&P 500 index in the United States was up almost 25% from the start of 2020 through to the end of 2022 — and that includes last year's 19% decline.

So that's two positive years and one negative, which, in historical terms, is pretty much par for the course. Over that same three year period, the S&P 500 compounded at 7.66%. Treasury bills were basically flat at 0.64%. The difference between those two is 7.02%, which is almost bang in line with the long-term average for the equity premium.

No one can tell you what the next three years hold in store, or indeed the next 30. But, once again, the investors who fare best will almost certainly be those who ignore the ups and down and focus on their long-term goals.

ROBIN POWELL is a freelance journalist and author, and is the founding editor of The Evidence-Based Investor and is the co-author of two books, the latest being How to Fund the Life You Want, published by Bloomsbury.

Important information:

This document is issued by Global Systematic Investors LLP (GSI) and does not constitute or form part of any offer or invitation to buy or sell shares. It should be read in conjunction with the Fund's Prospectus, key investor information document ("KIID") or offering memorandum. GSI is authorised and regulated by the Financial Conduct Authority (FRN 572537). The Company's registered office is 75 King William Street, London EC4N 7BE, United Kingdom.

The price of shares and income from them can go down as well as up and past performance is not a guide to future performance. Investors may not get back the full amount originally invested. A comprehensive list of risk factors is detailed in the Prospectus and KIID and an investment should not be contemplated until the risks are fully considered. The Prospectus and KIID can be viewed at www.gsillp.com and at www.geminicapital.ie

The contents of this document are based upon sources of information believed to be reliable. GSI has taken reasonable care to ensure the information stated is accurate. However, GSI make no representation, guarantee or warranty that it is wholly accurate and complete.

The GSI Global Sustainable Value Fund and the GSI Global Sustainable Focused Value Fund are sub-funds of GemCap Investment Funds (Ireland) plc, an umbrella type open-ended investment company with variable capital, incorporated on 1 June 2010 with limited liability under the laws of Ireland with segregated liability between sub-funds.

GemCap Investment Funds (Ireland) plc is authorised in Ireland by the Central Bank of Ireland pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (S.I. No. 352 of 2011) (the "UCITS Regulations"), as amended.

Gemini Capital Management (Ireland) Limited, trading as GemCap, is a limited liability company registered under the registered number 579677 under Irish law pursuant to the Companies Act 2014 which is regulated by the Central Bank of Ireland. Its principal office is at Ground Floor, 118 Rock Road, Booterstown, A94 V0Y, Co. Dublin and its registered office is at 1 WML, Windmill Lane, Dublin 2, D02 F206. GemCap acts as both management company and global distributor to GemCap Investment Funds (Ireland) plc.

GSI

Global Systematic Investors LLP

75 King William Street, London EC4N 7BE

Tel. 020 7717 5578

www.gsillp.com

Systematic factor investing. Sustainably.