

Client Update – The impact of COVID 19

With Coronavirus causing turmoil in investment markets globally we have seen significant market moves across asset classes over the past fortnight. 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 – both real and fake. Quite often the real potential impacts of such an event are not fully assessed apart from a gut reaction of blind panic. At times like these it is advisable to pause and consider the real-world outcomes for investors, and how we should evaluate investment decisions.

What has impacted investment markets are the multitude of warnings issued by companies indicating that their ability to operate and trade is being severely impacted. 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 - 13% to date.

From an investment perspective we are faced with two main choices:

1. *React **emotionally** and de-risk, as a reaction to losses and fear of further losses – with the intention of re-risking. This is a particularly hard trade to get right. At the time the bad news is happening, it is very difficult to see good returns again, not to mind in the near future. De-risking after a sell-off can result in **permanent losses** because failure to capture the initial re-bounce often sees investors stay out of markets.*
2. *The alternative approach is to act **rationally** based on an assessment of the facts. This could mean biding your time and watching for opportunities to add to equity allocations as you see value emerging (accepting fully that buying in falling markets is hard to do). Or it could mean accepting that the outlook for equities is materially impaired and then de-risking. As equities have fallen sharply, the first decision is whether the change in outlook is 'priced-in'. **History tells us that buying when fear is in the ascendancy has frequently been a significant source of wealth creation.***

There have been a few instances where sharp falls were followed by worse and where it would have paid to de-risk: cases include the *Tech Bubble* (2000/2001) and the *Global Financial Crash (GFC 2008/2009)*. In both instances, equity markets were significantly overheated and drove their own demise.

Temporary Correction

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 Ryanair shares which have taken a 26% drop in value in one week due to people not travelling. This is similar to what happened after 9/11 but the share price recovered within months. If we look at 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 26% in the past week, so it is clear what the market thinks, but is it rational?

Potential for Long Term Impact

There are scenarios where the impact of the virus on certain equities 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? 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. 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 the only commodity we know that experience less demand when prices fall. Phasing in is often a good start in cases like this, rather than trying to time the bottom.

There are always Reasons to Sell

If we look at US equities (a bellwether for the Global economy) since WW II there has been 15 bear market events (sell off of 20% or more in US stocks). There is always a reason to sell or not be invested. Yet as we can see from the chart on page 3 the one certainty is **time has rewarded the patient investor**. In addition, having a diversified portfolio has helped investors weather a market correction like we are now witnessing. That's where bonds, cash, property and commodities all help to play their part within a diversified portfolio.

Summary

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.

Reasons to Sell



Chart outlines the Total Return (including dividends) for the S&P 500 between 2009 and March 2020.

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