State of Play

27 January 2022

As uncertainty grips markets our Investment Specialist, Simon Durling, shares his thoughts on why market volatility can at times make for an uncomfortable investor journey when share prices fall sharply.

The shadow of uncertainty dominates markets

The expressions 'bull' market and 'bear' market derive from the way in which both animals react in conflict, either by the sharp rise of the horn or the heavy downward swipe of a paw. The terms are used to reflect when share prices are rising or falling with significant momentum as well as describing investor or market moods, for example to be 'bullish' or to be 'bearish' (optimistic or pessimistic). Benjamin Graham in the past has been described as the 'father of value investing' and describes the emotional and sometimes irrational behaviour of investors through the mood of the market in this quote: 'Price is a creature of the market's mood. In booms, it is set by the greediest buyer and in busts by the most fearful seller'.

For those of you who read State of Play each week, you will be familiar with the usual style: a combination of insight into topical economic or market events alongside providing an educational angle, with the primary purpose to inform retail investors on investment markets and what it may mean for their portfolios. Since the start of this year investment markets have been very

volatile with sharp daily movements in values, with the highs and lows during a single trading day highlighting the severity. This week's update focuses on the current uncertainty by picking out the key drivers and exploring why volatility can make investors so uncomfortable.

What is volatility?

It depends on the context, but within investing, and in particular stock markets, it is the variation in the price of an asset over a given timeframe. Clearly, if you focus in on just individual trading days, then depending on when that is, you can witness sharp deviations in share prices if the mix of uncertainty and the stage of the economic cycle combine to trigger a shadow of fear over investors. Importantly, time horizon is crucial. Investment solutions are usually designed over much longer timeframes of at least five years, but in many cases much longer. This helps mitigate and withstand periods of volatility, like now, when investors become fearful and share prices fall with great momentum.

What has prompted the recent market reactions?

So far, this year has been a prime example of market volatility being triggered by a combination of factors. Firstly, since the pandemic began in early 2020 and markets fell sharply in value, most stock market indices have enjoyed reaching new peaks towards the latter part of last year. The US market, which is dominated by companies which have benefited the most from lockdown restrictions, has seen extraordinary investment returns despite the worst pandemic seen in over 100 years. In some respects, this creates the first challenge mentally for investors as the high valuations for some companies when compared historically begs the question, 'are markets too expensive?' Clearly it depends on what calculation is used to compare, but using an older method like price versus future earnings (P/E ratio), then the current P/E ratio of 39, compared to a year ago when the ratio was at 34 and then to the last 50-year average which was just 21, the market, you would argue, is overpriced.

However, the dynamics of financial conditions are very different now when compared to the early 1970's. Ultra-low interest rates and vast quantities of additional money printed to first support the economy after the financial crash, but more recently, to provide stability in the wake of the pandemic, make a comparison like this look too simplistic. Also, some companies, like Apple, have continued to grow their revenues exponentially each year for more than a decade, making predictions of future earnings growth just guess work. Yes, it is possible to evaluate the short-term prospects of a company which is growing fast, but when innovation and improvements in productivity and product design overtake the normal, longer-term assessment becomes

more difficult. Many experts have called the peak of the share price of companies like Apple recently, only to watch as both their revenues and profits skyrocket thus dragging the share price with them.

Financial backdrop is changing

Another additional factor for questioning the value of shares currently is the changing financial environment where reopening economies and supply disruptions, coupled with soaring energy prices, have sparked inflation back to life. This has forced central banks and policymakers to rethink their plans for interest rates. Two immediate problems may happen as a consequence of sustained higher price rises compared to the last two decades. Firstly, higher interest rates push up the cost of borrowing for companies thus hurting future profits as central banks increase their base rates to cool economic growth and consumer demand. Secondly, additional costs for raw materials, manufacturing, and distribution mean that again profits are reduced unless the costs are passed on in full to the end consumer. This aspect is not binary. The reality is that borrowing costs will no doubt rise over time, but much depends on how many rises, by how much and how often in the next couple of years. Also, one major benefit of shares as an asset class over fixed income for example, is companies can pass on a proportion of these costs in price rises whereas bonds are fixed, hence their asset name. Shares therefore tend to offer better protection against inflation over the longer-term than fixed income but have the added side effect of volatility.

Why? Stock market participants, like fund managers, institutional investors and large investment houses constantly assess and analyse what might happen in the future by factoring in vast quantities of information and data to attempt to accurately plot a path to deliver investment returns for their clients and manage their portfolios or funds against an agreed level of risk. When the future appears more uncertain and difficult to navigate, instead of a vote of confidence, investors scatter in different directions driven by varying assessments of their version of the road ahead. All professional investors are sharing the investment market with smaller, less experienced, and less knowledgeable investors. Emotions begin to play a more influential role when markets fall sharply. What is known as a 'herd mentality' can overwhelm individuals, and where prices fall investors start to sell regardless of their objectives and time horizon. This can lead to a poor investment decision by individuals at precisely the wrong time, but importantly provides sufficient energy to pull prices even lower. This leads to more fear and more selling, with many investors becoming overly pessimistic and dragging markets still lower.

Political tensions in Ukraine

The final ingredient which has added to the uncertainty in the last week is the rising political tensions over Ukraine. A significant build-up of Russian forces has prompted the US, UK and other European countries to urge President Vladimir Putin to pull back from the brink of potential conflict. The US has placed about 8,500 troops on standby for possible deployment to central and eastern Europe to shore up NATO's (North Atlantic Treaty Organisation) defences as western leaders pledged to form a united front against the threat of a Russian invasion of Ukraine.

Clearly geo-political tensions like this are outside of investment theory and whilst assessing the possible implications, it is impossible to know the outcome, so investors just see additional uncertainty adding to the volatility that already existed prior to these new events emerging. The S&P 500 Index, which tracks 500 of America's biggest companies, entered correction territory for a while on Monday (24 January) having fallen by more than 10% since touching a record high three weeks ago, but it closed up 0.3% on the day at 4,410.[1] The technology-heavy NASDAQ Index swung from over a 3% loss during the trading day to end up gaining 0.6% at 13,855.13.[2] On Tuesday (25 January) the US market was yet again falling despite most European indices making gains.

Volatility can represent investment opportunities

Volatility and falling prices can create buying opportunities. One of the most famous investors, Warren Buffet, once said: 'I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful'. Only sell when prices are elevated and buy when prices have fallen - the principal is a simple one, but hard to execute effectively especially when you are not sure if markets have peaked or when markets have reached a new low point. Therefore, individuals often seek professional advisers to act as the unemotional third party on their behalf. They spend time assessing their objectives, their timeframes and most importantly how comfortable they are with investment risk. Once this has been agreed an investment decision is reached and implemented, typically, their investment portfolio will be spread across different asset classes to achieve the appropriate diversification.

Another famous investor Sir John Templeton once said, 'the only investors that don't need to diversify are those that are right 100% of the time', so simple but so true! If you are right 100% of the time you don't need to diversify and spread your money across different assets. Nobody, including market experts are infallible and therefore diversification is a necessity to avoid the risk of capital loss that can't be recovered from. Clearly, for some, investing when markets change in price so much and so often needs a certain amount of courage, but the important thing is sticking to an appropriate

financial plan and reviewing this regularly. If you are in any doubt reach out to your professional adviser for reassurance that your investments remain appropriate for your circumstances. To summarise, remember it pays to remain focussed on the horizon, not the pothole on the road just in front of you and as the saying goes, time in the markets, not timing the markets.

Find out more!

Listen **here** to our latest Market Views from Stefano Amato, Head of Multi-Asset Solutions UK, as he shares his thoughts on the main themes dominating markets.

Note: Data as at 25 January 2022.

[1] Investing.com - S&P 500 Overview, 25/1/22
[2] Investing.com - NASDAQ Overview, 25/1/22

Important Information

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