Drawdowns: Seismic events in Investment markets

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets." - Peter Lynch - Fidelity

As participants in the investment economy we're always trying to get a handle on 'risk' – that most elusive and intangible of investment terms. To some investors risk equals loss of capital, to others it means volatility. And it can be extended: the risk of not meeting financial goals, the risk of picking the wrong fund manager or following the wrong investment plan. The point here is that there is no singular definition of risk, and in the absence of a convenient definition we should spend our time, as Peter Lynch recommends, understanding our investments so that we are prepared when risk 'happens'.

Capital drawdowns are often seen as 'risk's' torch bearer. Precipitous declines in capital markets which directly impact the end investor – both financially, and psychologically. Looking back through history, drawdowns don't happen by accident. The drivers of global market crises tend to have common elements: market valuation, debt, war, human psychology, and more recently: computers.

Strong equity markets in SA over the past 12 years matched with various global meltdowns have created a national psychology that local investing is relatively low risk. The impetus to take money offshore over this time has been low (although more recently it appears this could be changing): if SA shares can do the job, why do I need to invest in what appears to be a more precarious global market? But how relevant is this recent past in gauging the potential for capital drawdowns in our home market? Looking back over the past 40 years tells us a slightly different story: the JSE has fallen 30% or more on six separate occasions, while global developed equities have fallen by this amount only twice, both of which are in recent living memory, and which are now embedded in the investment psyche. This makes rational sense: South Africa is a less diversified, economically and politically sensitive economy with a liquid currency often used opportunistically by global investors. A recipe for drawdown risk if ever there was one.

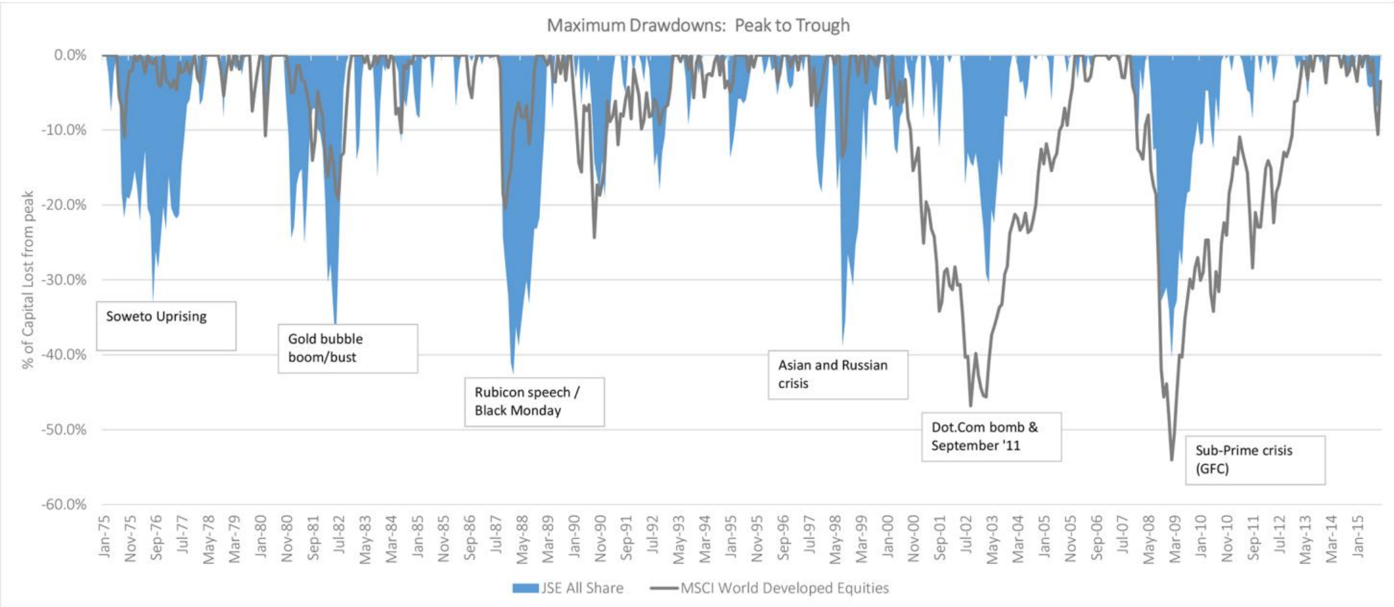

Chart 1: Capital Drawdowns in equity markets, from peak to trough

What can we make of this disparate view where global investing is perceived as higher risk than SA? Well firstly, there may be some truth to it. With the rise of global investing (as opposed to domestic investing), capital markets increasingly 'move as one' and contagion effects create additional pressure on prices through the 'risk on/risk off' trade (South Africa, as you would imagine, gets punished in the risk off trade: the derisking of global investment portfolios). Market momentum is also increasingly driven by computers where mathematical trading programs automatically trigger sell orders if certain metrics are breached. This was spectacularly evidenced in the "flash crash" of 2010 where US markets fell almost 10%, and recovered, within 36 minutes.

Drawdowns also don't just apply to equities. Listed global real estate fell by over 60% during the sub-prime crisis (2008/2009), and South African Bonds have experienced a 60% loss from 1947 which took over 50 years to recover.[1]

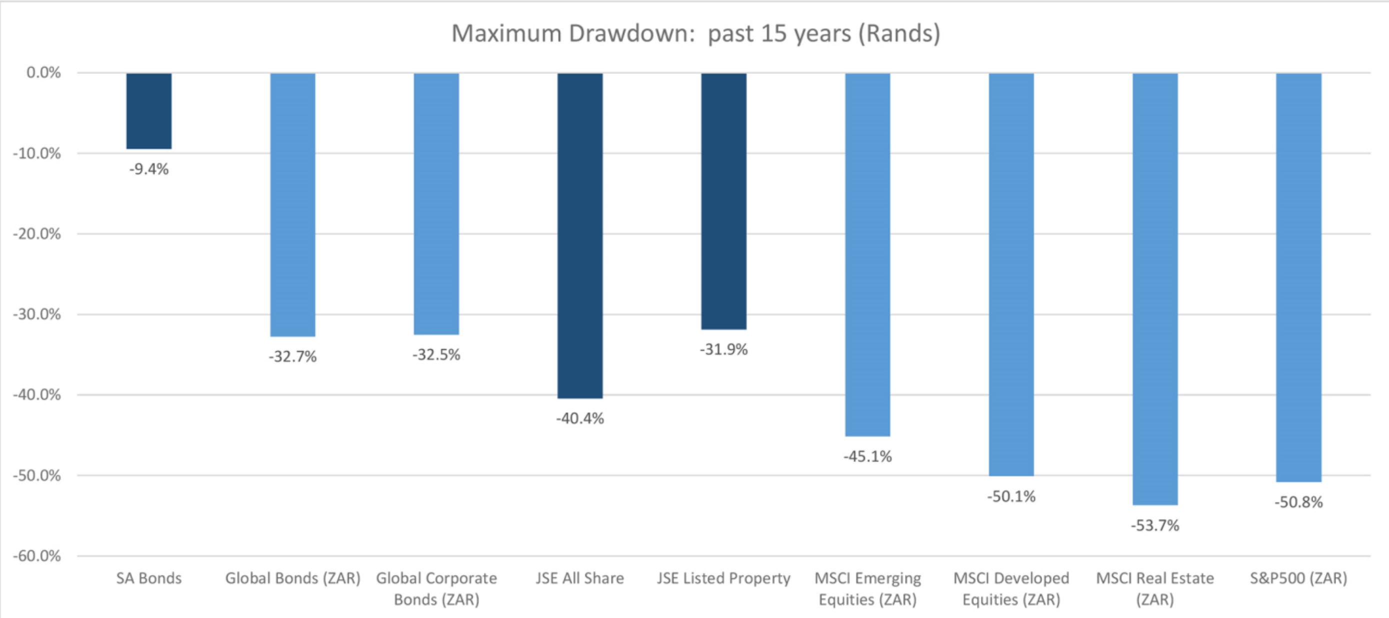

Chart 2: Maximum drawdowns per asset class in Rands

Drawdowns can happen to currencies too – particularly the Rand. It's a currency which weakens quicker than it recovers. For local investors the depreciating rand tends to dampen drawdowns (offshore investment returns are boosted by a depreciating currency, when measured in rands).

A capital drawdown in itself is a paper loss – this only becomes a realized loss if the investor reacts to the negative sentiment and psychology and acts on the event, selling when markets are weak. The unfortunate payoff here is that in most cases this action is too late and losses are already material, and to compound matters the same investor misses the rebound, when the market corrects. But that is an oversimplification – in reality market drawdowns can take months and even years to attain the same levels they had reached prior to the crash.

What can we do as investors? One element we can control – the only 'free lunch' in investing – is diversification. Market crashes happen indiscriminately no matter where you are on the globe or which asset class you are invested in. Diversification across asset classes, regions and currencies helps to isolate investors from a seismic event which can have a material impact on wealth and lifestyle.

1 Source: MacroSolutions

The second element we can control is our own investment behavior. Avoiding negative reactions during times of market stress can help protect savings in the majority of cases.

How likely is a severe capital drawdown today? Well the basic conditions are there: high valuations, national debt, declining earnings in many markets, political risk (eg Russia), psychology (investor awareness that valuations are overdone) and the newcomers: the flash traders with their computers. This is not to say a drawdown is imminent, and the same conditions may have been present in many years of good market returns. In reality we can't predict these events, but we can be positioned for them in how we build portfolios and how we deal with risk when it happens.

31 October 2015

Sector		1m	3m	6m	YTD	1yr	3yr pa	5yr pa	10yr pa	10yr Vol
LOCAL MARKET INDICES (In Rands)										
FTSE/JSE All Share Index (ALSI)	ZAR	7.6%	4.8%	0.4%	11.3%	11.6%	16.6%	15.5%	15.9%	15.5%
FTSE/JSE SA Listed Property	ZAR	2.1%	3.1%	1.7%	15.6%	20.2%	19.4%	19.0%	19.4%	17.0%
SA All Bond Index (ALBI)	ZAR	1.3%	1.4%	1.5%	4.0%	4.8%	6.0%	7.7%	8.3%	7.0%
SA Cash Index (SteFI)	ZAR	0.5%	1.6%	3.2%	5.3%	6.4%	5.8%	5.8%	7.3%	0.6%
Balanced Benchmark [2]	ZAR	5.3%	4.6%	3.3%	11.8%	13.4%	16.0%	15.2%	14.4%	6.8%
SA Inflation (1 month lag)	ZAR	0.0%	1.0%	2.7%	4.6%	4.6%	5.5%	5.5%	6.1%	1.4%
GLOBAL MARKET INDICES (in USD)										
Global Equity (MSCI World)	USD	7.8%	-3.4%	-4.1%	-0.2%	-0.1%	9.4%	6.9%	3.6%	16.4%
Emerging Markets Equity (FTSE EM)	USD	6.4%	-7.2%	-18.2%	-10.1%	-14.9%	-2.2%	-2.6%	6.5%	23.7%
Global Bonds (Barclays Global Bond Index)	USD	0.2%	0.8%	-1.2%	-2.0%	-3.1%	-1.5%	0.6%	3.9%	5.6%
Global Cash	USD	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.2%	1.6%	0.6%
MAJOR INDICES BASED TO RANDS										
FTSE/JSE All Share Index (ALSI)	ZAR	7.6%	4.8%	0.4%	11.3%	11.6%	16.6%	15.5%	15.9%	15.5%
Global Equity (MSCI World)	ZAR	7.7%	5.7%	10.8%	19.1%	24.8%	27.7%	22.6%	11.4%	13.3%
Emerging Markets Equity (FTSE EM)	ZAR	6.2%	1.6%	-5.6%	7.3%	6.3%	14.1%	11.7%	14.4%	15.4%
COMMODITIES										
Gold (US Dollars)	USD	3.2%	6.6%	-3.6%	-3.8%	-1.5%	-12.4%	-3.0%	9.4%	19.2%
Gold (Rands)	ZAR	3.0%	16.7%	11.3%	14.9%	23.0%	2.2%	11.3%	17.6%	21.4%
Currencies (positive return = Rand weakening)										
Rand / Dollar	ZAR	-0.1%	9.4%	15.5%	19.3%	25.0%	16.6%	14.7%	7.5%	16.2%
Rand / GBP Pound	ZAR	1.8%	8.3%	16.1%	18.2%	20.6%	15.0%	13.9%	6.0%	14.5%
Rand / Euro	ZAR	-1.2%	9.4%	13.8%	8.9%	10.2%	10.6%	9.5%	6.6%	13.6%

Spot Rates

	31-Oct-15		10-Nov-15	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Currencies	Rand/US$	Rand	14.25	13.82	11.28	6.96	6.33	3.65
	Rand/GBP	Rand	21.55	20.93	18.28	10.92	11.20	5.76
	Rand/EUR	Rand	15.30	15.46	14.24	9.47	7.66	4.34
	Rand/Aus $	Rand	10.03	9.68	9.86	6.71	4.85	2.76
Rates	Libor 6m $	US$	0.59	0.53	0.33	0.46	4.23	N/a
	Prime	Rand	9.50	9.50	9.25	9.50	10.50	18.50
	Repo Rate	Rand	6.00	6.00	5.75	6.00	7.00	N/a
	All Bond Index Yield	Rand	8.65	8.54	8.42	8.51	9.67	13.77
Commodities	Gold ($/oz)	US$	1,089.50	1,115.05	1,208.83	1,309.34	469.20	383.55
	Palladium	US$	601.00	661.00	775.00	573.00	194.00	142.25
	Platinum	US$	902.00	906.50	1,301.50	1,655.00	929.00	423.00
	Oil (Brent Crude) $	US$	47.43	48.54	94.74	81.25	63.77	16.30
Inflation	SA Inflation	Rand	N/a	4.60	5.90	3.20	4.40	6.40

data provided by Profile Data Analytics and INET BFA