

Flight to Safety

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Until very recently, the steady stream of bad news about the global economy, combined with rapidly declining portfolio values, made many investors contemplate selling their equity positions in advance of further anticipated losses. The purpose of this brief is to explain some of the trade-offs and corresponding risks of such an action, and to provide a quick reminder about the way markets work. I hope this offers some rational perspective to these very emotional times.

The chart on the back page is an unfortunate reminder of the severity of peak-to-trough declines in various global equity asset classes. As you can see, the left side of the chart is the percentage decline in the markets while along the bottom are corresponding asset classes organized in terms of lowest-risk to highest risk.

Changes to portfolios are common when your risk preferences change or the portfolio falls outside of your target asset allocation of bonds vs. equities. Before making significant changes to your portfolio, it is important to clearly understand the consequences any changes might have on your long term financial plan.

When assessing your portfolio, the following are some key points to consider:

Risk Trade-Offs

An investor wishing to sell-out of equities has a desire to eliminate market risk. However, doing so magnifies the risk of losing purchasing power. For example, a shift to risk-free investments such as money market securities are almost guaranteed to lose money after taxes and inflation.

Risk management requires a careful assessment of the trade-offs associated with reducing or eliminating some risks at the expense of increasing or taking others.

The following are three of the major risks that require consideration:

Market risk - the risk that stock prices will decline

Inflation risk - the risk of losing your long-term purchasing power

Longevity risk - the risk of outliving your money

The bottom line is it's important to remember that risk is multi-dimensional. Any decision to increase or decrease risks at the expense of others should be viewed as a long-term decision made with a thorough analysis of the trade-offs.

Expectations and Market Timing

Another likely reason investors are contemplating the move away from equities is that they simply wish to ride out the storm in the shelter of a "safe" harbour. In other words, they have chosen to become market timers, which poses other significant problems. For example, once investors make a call to sell out of the market, the next question is when to get back in. As we've seen recently and in many market cycles preceding this, even experts are not able to time entrances and exits of their positions with any consistency.

Market prices are set based on expectations from all public information.

Extrapolating the recent past, and assuming stock prices will continue to fall amidst the doom and gloom, implies that new information will be worse than expected. I think it's safe to admit that "news" is unknowable and unpredictable, especially in terms of how it stacks up against expectations already priced into equities.

Market Equilibrium and Expected Returns

Market efficiency implies that risk and return are related. So, if economic doom and gloom represents an increase in risk, market forces create a drop in stock prices. This is a very powerful concept and one that might seem counter-intuitive. However investors accepting the risk of buying or holding stocks in an environment filled with pessimism, uncertainty, and volatility are incented by lower prices and higher expected returns.

So, for every investor choosing to offload risk by decreasing equity exposure, someone else must take on that risk by increasing equity exposure. One side of

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the trade will not systematically “beat” the other. It is a risk preference that should be carefully considered before deciding on which side of the trade to be.

In other words, since you’ve already experienced the risk, it may not be prudent to move out of stocks. It may make sense to consider sticking around for the higher expected returns that are associated with lower priced stocks.

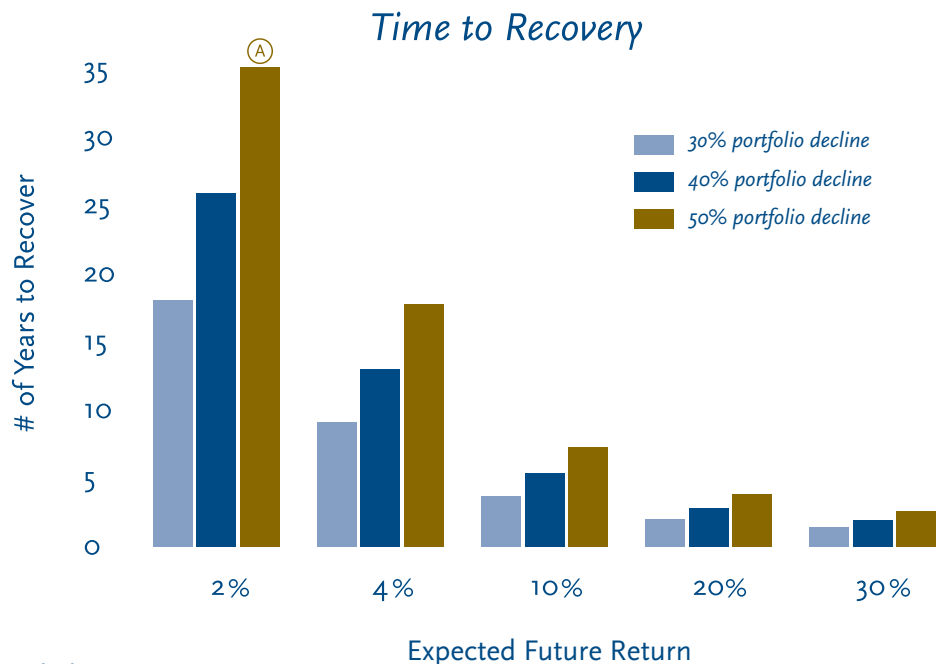
With the risk already factored in (our minds), rather than dwell on declining portfolio values, we’ve tended to view the drop in stock prices as a sunk cost (i.e. a cost that has been incurred and cannot be reversed). Investors should take the emphasis off the recent decline in value and focus on the recent increase in expected returns.

Time to Recover

An alternative to staying the course for higher expected returns is switching your portfolio to perceived risk-free assets, like GICs or cash, that offer lower expected returns. But by trying to eliminate market risk you’re now potentially increasing your risk of losing purchasing power or outliving your nest egg.

For example, the above table shows the approximate number of years to recoup a 30, 40, or 50% decline assuming various rates of expected future returns. So before trying to eliminate market risk from your portfolio, its important to consider these possible scenarios.

Let’s take a look at one of the more extreme examples above (See “A”): a 50% market decline and a 2% expected return going forward. In this case, if an investor were to move to cash today, they may need to wait between 18-35 years (ignoring taxes, transaction costs) to recover depending on the severity of the portfolio decline.



So in conclusion, it’s important to remember:

Risk is multi-dimensional: Eliminating one risk may magnify another.

Stock prices and the business cycle: A recovery in stock prices tends to lead a recovery in economic conditions.

Risk premiums and economic conditions: Risk premiums tend to be countercyclical (i.e., lower when economic conditions are stronger & higher when weak).

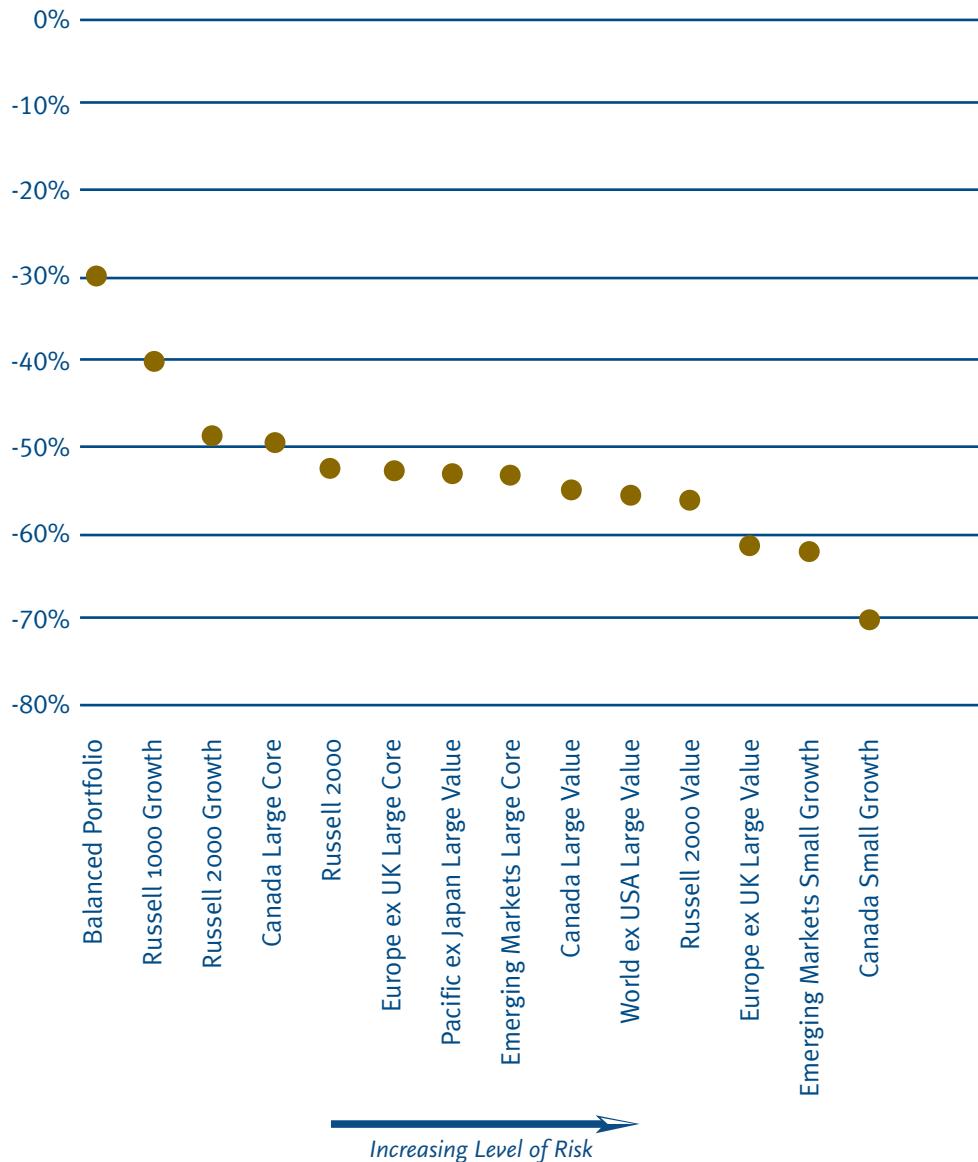
Prices reflect all current information: More bad news will not necessarily cause further stock price declines; it is news relative to expectations that matters.

Payback time: Weigh the upside of higher expected returns against the probability that equity markets will not reach previous highs within a reasonable time frame vs. the long term payback period from a perceived risk-free investment (i.e. GICs).

The decline in stock prices has certainly been dramatic and painful for everyone. But, I hope the above has helped to explain some of the trade-offs and corresponding risks of selling-out equity positions. In fact, given the recent market activity (at the time of writing the TSX was up 40%), those investors on the sidelines waiting for the “right moment” lost potentially 10-20 years of recovery.

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Global Major Asset Class Returns Performance From Peak to Trough to March 31, 2009



NOWHERE TO HIDE: The chart above is an unfortunate reminder of the severity of peak-to-trough declines in various global equity asset classes. As you can see, the left side of the chart is the percentage decline in the markets while along the bottom are corresponding asset classes organized in terms of lowest-risk to highest-risk.

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