Taking the emotion out of risk

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Eight years ago, the S&P 500 hauled itself off the bottom of the ocean and started to float upwards. Investors brave enough to peer into the murky depths of post-crisis seas and buy into the index in March 2009 have seen close to a fourfold increase in their money. The question today is whether stocks can continue this upward trajectory, whether they will just bob along, or whether dark seas will once again reclaim them.

In other words, how do we deal with late cycle risk?

The question is ignored by many investors, who fixate on potential returns and overlook the risks to their capital. Retail investors, in particular, see rapid rises in indices and jump on board for fear of missing out. Alternatively, hitherto risk-averse investors move out of safer assets and into equities in the quest for higher returns than bonds can offer. But their move may well be into the wrong assets at the wrong time. They typically regret their decision, sell the assets in disgust and immediately crystallise a loss. We've all been there at some time in our lives.

Taking emotion out of it

Decisions to buy and sell are often based on emotion. Fear and greed, yes, but also despair and excitement, and a whole boatload of other emotions besides. None of them are helpful for making investment decisions.

What is required, says David Vickers, a senior portfolio manager at Russell Investments, is a robust process. “Last year was volatile with a lot of event risk and it’s likely to be the same going forward,” Vickers told financial advisers at Russell Investments’ Adviser Sphere Event.

Sticking to a process helps avoid making bad decisions because of market “noise” and emotional reactions to the noise. Investment process should focus on valuation, cycle and sentiment, which all have different time horizons, Vickers says. Valuations can lack predictive power over the shorter term, but over the long term they correlate to expected returns. The economic cycle, which last year was dominated by Brexit and the election of Donald Trump, drives prices in the medium term. This year, the cycle will undoubtedly be impacted by politics in continental Europe, among other events. Finally, sentiment is the short-term indicator of where markets are right now. Are investors pessimistic or optimistic? It is quite possible to measure euphoria, for instance – using fund flow data.

Vickers thinks investors are, unusually, currently both pessimistic and optimistic. “This is the most unloved bull market in history,” he says. It’s as if no-one quite believes in it, despite its longevity and strength. Maybe there are still scars from 2000 and 2008 or perhaps investors see the main driver of the rally as QE, which is currently being switched off. Whatever the reason, investors are uneasy.

What does this mean for portfolios?

While all stock markets have risen sharply in recent years, the rises are not uniform and the risks in each of them are diverse in type and size.

US equities have risen fastest and carry the biggest risks. While many economic and fundamental indicators are positive, there are warning signs too. US price-earnings multiples, for instance, have only ever been higher than today on three occasions – in 1929, 2000 and 2008.

US CAPE: richest ever outside of 1929, late 90s

Source: Robert Shiller, Yale University. 25 January 2017.

So stocks are expensive. In fact, at current valuations, long-term equity returns over the next 10 years are expected to be 3%. This compares with yields on Treasuries of about 2.5%. If inflation averages 2%, this is a real return of 1%, which is a tiny reward for investors who are taking considerable risk.

In short, in Vickers view, it's not a sensible bet. Which leads us to other markets, such as Europe, where profit margins are currently much lower than in the US, giving scope for rises. Whereas the US cleared its banking system of debts in 2009-10, Europe is only now emerging from its debt crisis. As banks start to lend again, earnings should accelerate. The signs are there already: previously awful manufacturing PMIs are now moving in the right direction and strong earnings growth is predicted in Europe.

The most attractive market on paper is Japan. Valuations are hard to judge because of Japan's "lost" decades, but margins are low and rising and expected profits are on the rise.

Emerging markets are also attractive, even though they are not as cheap as some would like to argue. Emerging markets indexes contain many state-owned companies that make little money and the return on equity overall is poor. But return on equity is improving and a rerating is possible. Emerging market currencies are definitely very cheap, Vickers argues, with the Mexican peso, for one, falling by 50% versus the dollar. Emerging market debt is a more appropriate way than equities to exploit

value in emerging market currencies.

Is the US about to sneeze?

When the US sneezes the rest of the world catches a cold. Despite decades of global growth, this aphorism is as true as ever. So even if investors overweight Europe and Japan, they are likely to experience losses (or at least volatility) if US stocks fall off a cliff.

So is the US about to succumb? It looks too early to call an end to the current cycle. The risk of a recession, the event which always drives markets down, is not yet high. Leverage, a key driver of recessions, is sustainable and affordability is not yet an issue. While governments are heavily indebted and companies are started to take on more debt, consumers are relatively unencumbered.

But, as always, there are no guarantees. Investors can only control what they themselves do and having a robust process is key to that. Cash may also be key. In volatile markets, dry powder both protects investors and affords them opportunities.

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