

Schroders

Talking Point

Standing back from the turmoil

Ken Lambden – Global Head of Equities at Schroders – asks what does this mean for equities managers?

Old heads often like to respond to latter day crises with a dismissive comment of “it’s not as bad as...”, followed by a reference to some event that they themselves lived through and survived. Well that’s tough to do these days as we are going through a crisis which comfortably surpasses anything seen since the Great Depression. My generation has had to deal with such market events as the ’87 crash, the Asian crisis and the tech bubble. While these were all major ructions in their day none had the seriousness and all pervasive nature of this global pandemic of de-leveraging and risk aversion.

It’s been correctly observed by many now that the scale of the crisis has required far more by way of policy response than the event-driven, slow and largely locally-focused action we had seen up until last week. Readers of financial history will know that one of the keys to a successful policy response is speed because once lost confidence is extremely difficult to rebuild. However, whilst a meaningful response has been slow, the broad and co-ordinated nature of what’s now being put in place is a significant landmark. The dual effects of securitisation and globalisation mean the crisis was never going to be solved within any one set of borders.

Systemic issues and financial risks are not behind us yet, but given the gravity of the policies announced last week and today, we can now start to feel confidence that governments and central banks are prepared to take whatever action is required to stabilise the situation. The focus of investment markets is now very likely to move on to a new phase during which investors will begin to pay more attention to the impact the ‘credit crunch’ has had on economic growth and corporate profitability.

The process of de-leveraging has already moved inexorably into the wider economy and will have a significant impact across all sectors. The consumer, one of the major drivers of the bull market (remember that?), needs to constrain spending and rebuild savings. The stand off in debt markets will impact capital investment plans across all industries. Understanding how these forces will affect corporate profitability will be vital when making stock selection decisions. Earnings growth of around 10% is still forecast by a number of research teams across Pan Europe but it’s a mirage. Large downgrades are inevitable.

The focus of many portfolio managers will have to change to meet the challenges of the new investment landscape. Many investors have generated returns in recent years by following price momentum in certain sectors and markets. Resource stocks for example have, until the last few months, spiralled upwards on the back of commodity demand from the long-term structural boom in the emerging markets of China and India. The arguments on which the resource boom was based were in most cases very logical but the problem was that valuations after a time were not. Such momentum-based markets can for a time be very forgiving as returns are generated by simply locating a trend and riding with it – but that game is over. Fund managers will need a broader set of skills and capabilities.

Old values for a new landscape?

More fundamental analysis will be required now. A lower growth outlook demands that greater attention be paid to assessing which companies have the right business models and competitive positioning. Fund managers will need to build confidence in the source and sustainability of funding, cash flow and earnings, and will look to ensure that any investment has some margin of safety built in through valuation. Dividend yield, where well covered, will become a relatively more important part of investment returns. Some fund managers, perhaps those used to swimming with the tide of momentum, will find it difficult to make this adjustment to their stock selection process.

As the character of markets has changed so to has the way investors view the concept of risk. Riskier assets should ordinarily offer the prospect of higher returns through relatively lower valuations yet a diminution of stock volatility in the recent momentum-driven markets had lulled investors into a false sense of security. As a result, risk had in many instances become mis-priced and we are now seeing markets address that with a vengeance.

Followers of the various risk models used by portfolio managers to analyse the construction of their portfolios will be aware that over the last five years or so, metrics like tracking error have fallen in a material and sustained way because of a drop in volatility levels. It's long been our view that this has given a misleading impression of portfolio positioning (one of the reasons we have put more emphasis on risk measures such as 'active share') and has resulted in some managers unwittingly building portfolios that haven't been consistent with their objectives. Expect tracking errors to start moving back to more realistic levels.

A natural reaction to aggressively falling markets is to fill portfolios with defensive stocks in the hope that the worst falls in profitability will be avoided but at this stage that's not necessarily where the opportunities lie. Defensive sectors such as utilities, food and health care have delivered strong outperformance over the last year and now generally trade at large premiums to the market. Due to heightened risk aversion we have begun to spot a number of opportunities emerging in various stocks, sectors and markets that may not have appeared on the prudent investor's radar screen for some time.

The paradox of investing is that, more often than not, actual risk is highest when the decision to invest feels easiest. Rising markets, give us instant proof of our 'good judgement'. For the long term investor however stock risk across the markets is actually abating as valuations fall towards their lowest levels for 10 - 20 years.

Investing with a long term investment horizon in mind is sometimes unfashionable but in times like this it's the only way to go. You won't find the words 'panic' and 'short-term' next to the entry for 'wealth creation' in the investment lexicon.

It will take a while but we will find our way out of this. When we do we'll be well positioned for the next market challenge – at which time I can fairly confidently predict we can say "it's not as bad as the credit crunch of 2008".

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