Managing survival instincts during market volatility

As members and associate members of the Association of Financial Mutuals, and more importantly as human beings we are all in this together. As COVID-19 continues to cause disruption and pain in both our personal lives and for businesses around the globe, we hope this article helps make sense of the current market environment and provides guidance on how to protect your portfolios by managing your survival instincts during this period of uncertainty.

Despite Markets rebounding sharply last week, with the MSCI All Country World Index surging approximately 11%, we believe the market volatility will continue and a 2020 recession seems likely. However, nothing, especially volatility lasts forever. There have been many times throughout history where markets have pulled back - but these relatively short periods are most often followed by the most favourable returns. Unfortunately, due to loss aversion - one of the principles of behavioural economics - people tend to remember the bad twice as much as the good. This means that despite having experienced the longest bull run in history, a short period of weak performance in the markets can cause investors to rethink their long-term investment strategy. We discourage this and instead believe you should hold your nerve and stay true to your long-term plan.

Fear, greed and fundamentals

On 17 March, the fall in the U.S. stock market was the third-worst performance day in history. This was mostly driven by sentiment and has been for the majority of the sell-off period. Sentiment is just a nice way of saying fear.

It has been long said that fear and greed drive the market in the short-term. In the long-term, however, fundamentals ultimately determine the price. When we say fundamentals, what we are really saying is that the future earning potential of a stock will ultimately drive its value. Now, let's use the MSCI World® Index as an example. At the time of this writing (27 March 2020), the MSCI World is 25% lower, in U.S. dollar terms, than its 19 February high.

If fundamentals drive stock prices in the long-term, then there is a simple question to ask: *Will the negative impact of COVID-19 reduce the future earnings potential of the average stock in the world by 25%?* Easy to ask. More difficult to answer. We think believe the answer is no. However, we also believe that we need targeted fiscal stimulus in order to minimise the potential damage.

Clearly nothing in this world is that simple in its entirety. Other questions like: *were some markets too expensive to start with, such as the U.S.?* This will affect how much return you expect from certain markets and asset classes. But if we look to the future, we still believe that the earnings of the average stock will drive their stock price to be superior to those returns in other asset classes. In other parts of the world, the opportunity for high future returns are there, because they were not as expensive to start with. The UK is one such market that, on many valuation metrics, looks very cheap.

That said, the near-term looks ugly. First-quarter global economic growth may end up being positive, but rather anemically positive. The second quarter is setting up to be a significantly negative for global economic growth. If the virus follows the same path in Europe and the U.S., as it has in China and South Korea, with containment measures dramatically increasing across the globe, we hope to see a slowdown in the spread of the virus over the coming weeks. Provided that the virus is transitory - perhaps contained in the second quarter - the global economy should be poised to rebound in the second half of 2020. The global economy was in a strong place before the coronavirus struck in mid-January. Substantial monetary and fiscal stimulus combined with pent-up demand create the conditions for a sharp rebound if the number of new virus cases peaks early in Q2.

It is, however, important to note that whilst we are optimistic that we could see a rebound, there are several factors which remain uncertain, such as more aggressive containment measures in the U.S. and UK for instance.

That will be a lot of intense pain in a short period of time - and we are already feeling that pain in our personal lives. But will it really be enough to take away the average stock's ability to grow earnings in the future?

How does the current situation compare to the 2008 crash?

The current crisis is different than what the world faced in 2008, bear markets are unique in their misery. This one even more so as it's a pandemic bear market, rather than a financial imbalances or overheating economy created bear market. This one wasn't caused by tight monetary policy, so bank solvency is unlikely to be a problem this time around and if the stimulus measures being floated by governments around the world are effective, small- and medium-sized businesses will likely stabilise. Firepower from central banks is very limited this time around, as many banks either already have interest rates near zero, or are expected to soon. This means that any kind of major credit event could be cause for a bear market.

One similarity to previous bear markets is that we are seeing the type of volatility and panic that is associated with investor capitulation. The selling may not be quite exhausted, but many measures are now showing levels of panic not seen since the depths of the financial crisis.

Managing our survival instincts

Our survival instincts tell us that pain is bad and that we should distance ourselves from pain. This ingrained behaviour keeps us alive when our physical lives are threatened. The problem is that in too many cases, the fear overwhelms the intellect. That is why every global investor behavioural study has come to the same conclusion: that we as humans buy high and sell low and do it over and over again.

The main protections we have to combat this behavioural urge is a plan and a commitment to that plan. We have an investment strategy, and we diversify that strategy because we don't know what will happen next. We have a plan because we know that if we do not have a plan in times of uncertainty, we will give in to the fear of others in the market.

We do not recommend that you blindly follow your strategy without question. That is not what we are doing at all. We are asking ourselves that same simple question: will the impact of COVID-19 be significant enough to reduce the future earnings of the average company by 25%?

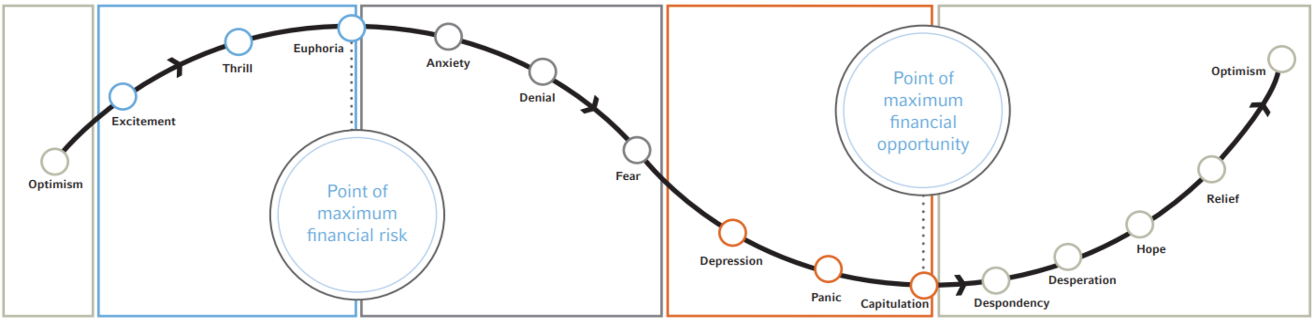
Again, our answer right now is no. That answer could change if the fiscal response necessary to keep companies and industries in business and save the jobs of their employees does not come to pass. At the time of writing, there has been over $2 trillion announced as a fiscal response to the pandemic, in the U.S. alone. To put that in context, U.S. annual GDP is $22trn, so the fiscal package equates to just under 10% of U.S. GDP. This stimulus is not limited to the U.S., across the globe over $5trn has been announced so far, that number is growing by the day.

The U.S. Federal Reserve (the Fed) has also announced that they will open up the commercial paper facility that they used in the Global Financial Crisis and effectively become the buyers of last resort for short-term financing vehicles. The market reaction has initially been quite positive to these developments, which were expected but nonetheless needed.

What does the future landscape look like?

From a market outlook, valuation appears more attractive, while sentiment is still a watchpoint. As governments around the world are taking the coronavirus outbreak seriously, the importance of taking a long-term view in your investment portfolio amid the volatility, and avoiding any rash decisions is obvious.

The chart overleaf demonstrates how market emotions may impact our investment actions and highlights the importance of taking a long-term view of your investment portfolio and staying invested in the markets.



	EXCITEMENT THRILL EUPHORIA	ANXIETY DENIAL FEAR	DEPRESSION PANIC CAPITULATION	DESPONDENCY DESPERATION HOPE RELIEF OPTIMISM
Market Cycle 1	30% Nov 1971 – Dec 1972 • Inflationary pressures. Productivity improvements • Rapid corporate earnings growth • Introduction of paperless technology	-15% Jan 1973 – Jan 1974 • OPEC Oil crisis – crude oil prices tripled. Inflation • Credit squeeze • Property company failures	-24% Feb 1974 – Nov 1974 • Global recession • Extended bear market	39% Dec 1974 – Jun 1975 • Stock market recovery despite recession
Market Cycle 2	136% Aug 1984 – Aug 1987 • Credit boom • Strong world economic growth	-2% Sep 1987 • • Irrational shareholder sentiment • Peak of overinflated stock values vs historical PEs	-28% Oct 1987 – Nov 1987 • 1987 Global stock market crash	64% Dec 1987 – Dec 1989 • Stock market recovery as value hunters sought to buy quality stocks cheaply
Market Cycle 3	99% April 1997 – Sep 2000 • Tech boom. Investor exuberance • Emergence of 'new economy' sectors	-28% Oct 2000 – Sep 2001 • Tech bubble burst • September 11 terrorist attack	-22% Mar 2002 – Feb 2003 • Reduced global economic growth forecasts • Extended bear market • Corporate accounting scandals	52% Mar 2003 – May 2005 • Geopolitical uncertainty • Refocus on world economic fundamentals • Boom in resources in response to industrialisation of China
Market Cycle 4	28% Jun 2005 – Jul 2007 • UK house prices hit highs • Credit boom • Higher interest rates	-17% Aug 2007 – Sep 2008 • Credit crunch. Sub-prime mortgage crisis. Collateralised debt obligation (CDO) failures • Lehman Brothers declares bankruptcy	-37% Oct 2008 – Feb 2009 • Global financial crisis • European and U.S. recessions. Negative real GDP reported for major developed countries in Q4 2008	225% Mar 2009 – Dec 2015 • Global stock market recovery • Deleveraging, slow economic growth
Market Cycle 5	40% Jan 2015 – Dec 2019 • Return to full employment in U.S. • Optimism rises with U.S. tax cuts • Trade war creates volatility in 2018 • 2019 Fed rate cuts extend the cycle			

Latest month end data as at 31 December 2019. Illustration purposes only.
Market cycle returns calculated using Ibbotson U.S. Equity Total Return Index from 1971–1978 and Russell 3000® Index from 1979 to 2019.
Any past performance is not necessarily a guide to future performance. Indexes are unmanaged and cannot be invested in directly.

As the chart shows, investors experience a range of emotions at different points of a market cycle. Unfortunately, this can often result in entering or exiting the market at precisely the wrong time. When markets dip, as investors we often feel panic and the fight-or-flight part of our brains urges us to exit the market. As investors, we must manage our survival instincts and not attempt to time the market or risk missing the best days. Exiting the market to reduce risk during a downward trending market can mean participating in a lot of the downside, potentially missing out on the upside.

What is the best strategy to get through this for investors in equities, Is it a question of holding on to your hat until it passes?

Extreme periods of market volatility are not unusual. We expect severe disruptions to global economic and earnings growth over the next few months, but we recognise that a lot of bad news is already priced in, limiting downside potential from here and providing a platform if the situation does start to improve. Valuations on risk assets have significantly improved, and we are now inclined to start modestly increasing the risk in our portfolios at more attractive levels.

Our strategists believe that the equity markets that have been hardest hit by the COVID-19 crisis should be those that benefit the most from the eventual rebound. The UK and Eurozone equities are attractively valued. Europe’s high weighting to cyclical stock should help it outperform in the recovery. We believe that emerging market equities could also benefit from the eventual recovery. They are attractively valued and will gain the additional benefit of reduced trade-war tensions.

Of course, there is concern and uncertainty surrounding the underlying equity earnings, cash-flow outlook, and ongoing/elevated draw-down risk. So, going beyond target to an overweight equity position is a different proposition which should be sized appropriately. We will likely enter an environment ripe with pent-up demand and aggressive monetary and fiscal tailwinds at our backs once these virus effects fade.

The importance of diversification in a long-term investment strategy

It is important to consider that like no member’s business is the same, neither are your risk and return objectives. Where some members may have high allocations to equity and can handle large drawdowns, others may have smaller allocations to equity within a more diversified multi-asset portfolio in order to achieve a smoother return path.

At Russell Investments, we define multi-asset investing as the process to identify, combine and dynamically manage a globally diverse mix of performance sources to reduce volatility and maximise the probability of achieving expected outcomes over the long term. A multi-asset portfolio has broad access to a flexible range of investment instruments that can seek out growth opportunities as the market environment changes, while carefully managing risk to enhance risk-adjusted returns. Dynamically managing a multi-asset portfolio rather than relying only on your strategic asset allocation can allow you to take advantage of short-term opportunities to improve returns or avoid unnecessary risk.

Disinvesting from equity before partaking in the rebound is not advised, but when the dust settles, adding new asset classes and creating a more diversified portfolio can protect your investments from future large drawdowns, creating a smoother return profile for your members. In fact, in times of uncertainty downside protection can matter more than upside growth.

For more information please contact:

Nathan Robinson

Associate, UK Institutional

+44 20 70246344

or email: nrobinson@russellinvestments.com

Important information

For Professional Clients Only.

The data contained within may be subject to confidentiality arrangements. The information provided may not be reproduced or disseminated outside your management group without Russell Investments' prior written consent.

Unless otherwise specified, Russell Investments is the source of all data. All information contained in this material is current at the time of issue and, to the best of our knowledge, accurate.

The information, advice and opinion given in this publication is given in good faith and based upon our understanding of your objectives and requirements. However, neither Russell Investments nor any member of its staff accept any liability in respect of any such information, advice or opinion. It is very important to do your own analysis before making any investment decisions.

The value of investments and the income from them can fall as well as rise and is not guaranteed. You may not get back the amount originally invested.

Issued by Russell Investments Limited. Company No. 02086230 and Russell Investments Implementation Services Limited Company No. 3049880.Registered in England and Wales with registered office at: Rex House, 10 Regent Street, London SW1Y 4PE. Telephone +44 (0)20 7024 6000. Authorised and regulated by the Financial Conduct Authority, 12 Endeavour Square, London, E20 1JN.

UKI-01859