Steady as she goes

KEY POINTS

WHAT IS THE ISSUE?
Trustees should appreciate that the complexity of investment markets can make financial crises hard to predict, meaning it is easy for financial professionals and clients to be caught unawares.

WHAT DOES IT MEAN FOR ME?
Appreciating the nature of market crises helps trustees appraise investment portfolio risks realistically, enabling a better quality of discussion with portfolio managers and clients.

WHAT CAN I TAKE AWAY?
By discussing the danger of market crises, you will help your clients better understand portfolio risks, thereby making an active contribution to fulfilling your fiduciary duties.

DR QUINTIN RAYER ADVOCATES CAUTION AND TRANSPARENCY WHEN DISCUSSING INVESTMENTS AND MARKET CRISES WITH CLIENTS

ALTHOUGH MARKETS regularly go through periods of falling prices, it is easy for trustees and other financial professionals to focus on the upside, directing relatively little effort towards spotting the next crisis. Press coverage is short term, with negative market events fading rapidly from memory. Discussions with portfolio managers and intermediaries tend to concentrate on the positives, neglecting the possibility of downward market moves.

Rising bond yields in early 2018, triggered by US tightening and perceived inflationary pressures, combined with protectionist rhetoric, may have spooked investors, while developments over recent years have demonstrated the power of political events to impact markets (for example, the UK's EU referendum and the US general election in 2016). In this context, it seems strange that those in financial services do not spend more time discussing the potential for future financial crises. One might expect these discussions to take place among financial professionals and trustees, and to form part of conversations with clients.

This article explores some ideas around the fundamental causes of financial crises, which are often deeply rooted in human nature. It also sketches a possible approach for better managing investments in the face of this uncertainty.

FINANCIAL CRISES

Like many investors, trustees know that stock markets are prone to periods of rising or falling prices, often referred to as 'bull' or 'bear' markets respectively. These can impact individual asset classes or be more widespread, although often refer to equities, unless otherwise qualified. For investors, they are a source of great concern, since a stock market crash can result in a decline of 25 per cent or more in real equity values.[1] Markets often appear to be driven as much by sentiment as by economic reality and, as Federal Reserve Chairman Alan Greenspan suggested during the dot-com bubble of the 1990s, can suffer from 'irrational exuberance'.[2]

Stock markets are perceived to be linked to economic cycles, but since participants seek to anticipate investment opportunities ahead of competitors, markets are forward-looking. To be forward-looking, investors must make judgments and forecasts about economic and investment outcomes with incomplete information. This results in decisions coloured by human psychological and behavioural biases, thus increasing the likelihood of error. With many market participants, a wide range of views are

generated and, logically, not all of these can be correct.

Even if normal economic cycles could be predicted from interest rates, unemployment rates and other data, national economies are subject to external influences from foreign countries via trade, governments' decisions and wider geopolitical events. Governments are prone to treating favourable shocks as permanent developments, fuelling spending sprees financed by borrowing, which eventually end in disaster. Some countries become 'serial defaulters' on their sovereign debt, tending to overborrow during good times, leaving them vulnerable during the inevitable downturns.[3,4] Alternatively, financial innovations can appear to render illiquid assets more viable, allowing them to command higher values than previously, such as during the US sub-prime mortgage crisis of 2007.[3] New technologies, including cryptocurrencies, can offer exciting possibilities, with bitcoin falling around 66 per cent between its peak in December 2017 and February 2018.[5]

The complexity of financial markets may make them prone to fingers of instability extending throughout the system and amplifying insignificant events, with potentially catastrophic consequences.[4] Financial markets may be seen as 'chaotic' systems, meaning that they are extraordinarily sensitive to the smallest influences.[6] Predicting the long-term future of any chaotic system is practically impossible, but, worse than that, financial markets may have a tendency to organise themselves into so-called 'critical states', which have a tendency towards sudden and tumultuous change. This suggests there may be no such thing as a 'typical' market crisis.

The economist Hyman Minsky noted that stability is causally linked to instability. For example, long periods of stability can lead to debt accumulation until dangerous levels of leverage are reached.[4] If markets are indeed in a 'critical state', it may be that well-meant initiatives implemented to avoid smaller problems can predispose markets to much larger crises.[6] Small corrections may be an indispensable component of the dynamics required to keep financial markets healthy.

SECULAR TRENDS

Secular trends can also significantly change the investment landscape, creating new opportunities while undermining others. Market practitioners generally have a range of opinions, and where some correctly anticipate trends, others do not. Further, the results of elections or national referendums may turn slight popular biases into clear-cut outcomes that can come as a surprise to the consensus view. Examples of secular trends include:

- the UK's 2016 EU referendum, the emergence of more nationalistic political candidates and the potential for protectionist US trade policies, all of which have contributed to market unease in 2018;
- new technologies, most recently including the cryptocurrency and dot-com stock bubbles – but these are hardly new phenomena, considering the similarly speculative landscapes of the 1840s (railway mania) and 1790s (canal mania);[7] and
- demographic impact as populations age, increasing demand for healthcare and associated support services, combined with disinvestment associated with drawdown from pensions.

PEOPLE AND POLITICS

Human nature often seems to lead to the over-anticipation of future developments (both good and bad) and exaggerated valuations. The fickle nature of human confidence also plays an important role.[3] People tend to prefer simple explanations, and any explanation rather than none; unfortunately, that does not mean such explanations are correct.[4] Leaders in the financial sector may believe that their innovations have genuinely added value and underappreciate the risks their firms are taking. Alternatively, financial product providers may be responding to inappropriate incentives in less-well-regulated areas. Almost all bubbles require some form of new financial technology or financial engineering.

One economic role that governments have is to maintain a balance between producers and consumers to ensure fair market prices. However, other forces are at work in politics, with constituencies attempting to influence governments through money, polling or petitioning. Governments respond to political influences both to silence critics and because these actions give them the means to stay in power. Market events can also provoke responses from financial authorities that, although intended to address current difficulties, are likely to sow the seeds of future problems, such as quantitative easing.[4] The resulting actions can lead to financial bubbles. In these ways, governments can exert power over financial markets and on public thinking in ways that can set things up for a future disaster.[8]

WHAT TO DO?

Managing portfolios in the face of these considerable uncertainties is challenging. These risks are unlikely to be captured by conventional risk measures (such as volatility, value at risk, etc). However, stress-testing portfolios may help.[9,10] With support from portfolio managers, trustees can identify particular issues associated with these risks and construct scenarios of possible outcomes that attempt to quantify asset movements. These can be based on significant historical market events or use invented scenarios that reflect particular concerns. If test results impact portfolios to an unacceptable degree, portfolios can be restructured to attempt to make them more robust to the scenarios considered.

SUMMARY

Anticipating market crises is not easy: financial professionals have to overcome their in-built human biases, as well as political and economic systems that can leave markets prone to periodic turbulence. Given the difficulties in anticipating such events, along with other market practitioners, trustees should constantly be on the alert, particularly during quiescent periods when everything seems to be sound and markets are generating consistent positive returns.

It may be difficult, but portfolio managers and trustees should be attempting to form judgments about the likelihood of developing market crises and discussing them with their clients. Such conversations should help ensure clients have a more complete and realistic understanding of the risks their investments may entail, and facilitate a better discussion around portfolio investment allocations.

1 R Barro and J F Ursua, 'Stock Market Crashes and Depressions', NBER Working Paper 14760, National Bureau of Economic Research (2009) **2** See Wikipedia, September 2016 (online), available at bit.ly/2G5j2hF (accessed January 2017) **3** C M Reinhart and K S Rogoff, *This Time is Different*, Princeton University Press (2009) **4** J Maudlin and J Tepper, *Endgame*, Wiley (2011) **5** www.coinmarketcap.com **6** M Buchanan, *Ubiquity: Why Catastrophes Happen*, Three Rivers Press (2001) **7** C P Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises*, 3rd edition, Macmillan (1996) **8** J Blessings, *The Anti-Demographic Cliff*, CreateSpace (2014) **9** Q G Rayer, 'Testing Times', *STEP Journal*, Vol 24 Iss 8 (October 2016), pp62–63 **10** Q G Rayer, 'Testing Times: Part 2', *STEP Journal*, Vol 25 Iss 3 (April 2017), pp66–69

DR QUINTIN RAYER IS HEAD OF RESEARCH AND ETHICAL INVESTING AT P1 INVESTMENT MANAGEMENT