ANALYSIS

Spotting the next crisis: Is it time for managers to pay more attention?

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Although markets regularly have periods of falling prices, financial professionals seem to focus on the upside, directing relatively little effort towards spotting the next crisis.

Press coverage seems short-term, with negative market events rapidly forgotten. Discussions with portfolio managers and intermediaries tend to concentrate on the positives and often the potential for downward market moves can seem neglected.

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

It may be difficult, but portfolio managers and intermediaries should be attempting to form judgements 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.

As recent events such as Brexit and the US presidential elections have shown, political events often impact markets with outcomes not anticipated by mainstream opinion. In this context it seems surprising that those in financial services do not spend more time discussing the potential for future financial crises. One might expect these discussions to extend both among financial professionals themselves and also to conversations with their clients.

'Irrational exuberance' of markets

Markets often appear to be driven as much by sentiment as by economic reality and, as Alan Greenspan pointed out, during the dotcom bubble of the 1990s, markets can suffer from 'irrational exuberance'.

Stock market values are perceived to be linked to economic market cycles, but since market participants seek to anticipate investment opportunities ahead of competitors, markets are forward looking. To be forward looking, investors must make judgements and forecasts about economic and investment outcomes with incomplete information.

This results in the likelihood of error and decisions coloured by human psychological and behavioural biases. With many market participants a wide range of views are generated; logically not all of these can be correct.

Even if 'normal' economic cycles could be predicted from interest rates, unemployment and other data, national economies are subject to external influences from foreign countries via trade, decisions made by their governments and wider geopolitical events.

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, while some may correctly anticipate trends, others will not. The results of elections or national referendums may turn slight popular biases into clear cut outcomes, which can come as a surprise to the consensus view.

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 plays an important role. Leaders in the financial sector may believe their innovations have genuinely added value, and underappreciate the risks their firms are taking.

Maintain a balance

One economic role governments play is to maintain a balance between producers and consumers to assure fair market prices. However, other forces are at work in politics, with constituencies attempting to influence governments either through money, polling or petitioning (the 'will of the people').

Governments respond to political influences both to silence critics and because these actions help them stay in power. Resulting outcomes can lead to financial bubbles, caused by governments creating artificial criteria to achieve political goals. Government can exert its power over financial markets and on public thinking in ways which can set things up for a future disaster.

What to do?

Managing portfolios in the face of these considerable uncertainties is challenging. The risks are unlikely to be captured by conventional risk measures (volatility, value-at-risk etc.). However, stress-testing portfolios may be able to help.

Managers can identify particular issues associated with these risks and construct scenarios of possible outcomes that attempt to quantify asset movements. If test results impact portfolios to an unacceptable degree, they can be restructured to attempt to make them more robust to the scenarios considered. ●

EXAMPLES OF SECULAR TRENDS

Rising nationalism: including the UK's 2016 Brexit vote, the election of more nationalistic political candidates, with potential for protectionist trade policies in contrast to previous eras of increasing free-trade.

New technologies: including, more recently, the dotcom stocks bubble (1990s). However, this is hardly a recent phenomenon considering, for example, the 1840s railroad mania and 1793 canal mania.

Demographic impacts: such as populations' age, increasing demand for healthcare and associated support services, combined with disinvestment associated with drawdown from pensions.