CRISIS MANAGEMENT: IFAS MUST DISCUSS MARKET RISKS WITH CLIENTS

Advisers should spend more time explaining the potential effects of future crises on client investments, despite their inherent behavioural biases and the unpredictability of politics

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Markets regularly have periods of falling prices, but it is easy to focus on the upside, directing relatively little effort towards spotting the next crisis. Press coverage can seem short term, with negative events rapidly forgotten. Managers tend to concentrate on the positives and the potential for downward market moves can seem neglected.

The Brexit vote and Donald Trump's US presidential election victory show political events often have unexpected market impacts. So it is strange financial advisers do not spend more time discussing the potential for future financial crises, among themselves and with clients.

SENTIMENT AND CYCLES

Stock markets go through bear periods. These are a source of great concern as stock market crashes can lead to declines of 25% or more. Markets often appear driven as much by sentiment as by economic reality and, as suggested by former Federal Reserve chairman Alan Greenspan, can suffer from irrational exuberance.

Market values are perceived to be linked to economic cycles, but since participants seek to anticipate investment opportunities ahead of competitors, they are forward looking. Investors must forecast economic and investment outcomes with incomplete information. This can result in decisions coloured by behavioural biases.

Even if 'normal' economic cycles could be predicted from interest rates, unemployment and other data, national economies are subject to influences from foreign countries. Countries may be serial defaulters on their debts, over-borrowing during good times leaving them vulnerable during downturns.

Governments can treat favourable shocks as permanent developments, fuelling a spending and borrowing spree that ends badly. Financial innovations can permit illiquid assets to command higher values than previously, such as during the US subprime mortgage crisis of 2007.

The complexities of financial markets make them prone to instabilities, capable of amplifying small events with potentially catastrophic consequences. Long periods of stability can lead to debt accumulation until dangerous levels of leverage are reached. National referendums or election results may turn slight popular biases into outcomes that can overturn the consensus view. Examples include:

- Rising nationalism, including Brexit, with potential for protectionist trade policies by contrast with previous eras of increasing free trade.
- New technologies. Witness the internet dotcom stocks bubble of the 1990s.
- Ageing populations, increasing demand for healthcare and pension drawdown.

Human nature may lead to over-anticipation of future developments and exaggerated valuations. People prefer simple explanations, and prefer any explanation rather than none.

Unfortunately that does not mean they are correct. Financial sector leaders may believe that innovations have genuinely added value while underappreciating new risks. Product providers may respond to inappropriate incentives in less well-regulated areas.

Governments can maintain a balance between producers and consumers to assure fair market prices. However other forces are present, with constituencies attempting to influence governments, including by polling. Governments respond to political influences to silence critics and help them stay in power.

Market events can provoke responses from authorities, which although intended to address present difficulties, may sow the seeds of future problems (such as quantitative easing). The outcomes can lead to financial bubbles, as governments create artificial criteria to achieve political goals.

PLANNING AHEAD

Advising on investments with these uncertainties is challenging. Conventional risk measures are unlikely to capture these uncertainties, however stress-testing portfolios may help. With support from managers, advisers can identify issues and construct scenarios of possible outcomes that attempt to quantify risks. If test results affect portfolios unacceptably, they can be restructured to make them more robust to the scenarios considered.

Anticipating market crises is not easy. Advisers have to overcome their human biases, and political and economic systems that can leave markets vulnerable. Advisers should be constantly alert, particularly during periods when markets seem sound and are generating consistent returns.

Although difficult, advisers should form judgements about the likelihood of developing market crises and discuss them with clients. These conversations should help ensure clients have a more complete understanding of the risks of their investments, and facilitate a better discussion around portfolio investment allocations. ■

READ ALL ABOUT IT: Spotting the next financial crisis is a tough challenge