Private Capital Advisers

2020 – A year we won't forget

All years are amazing in their own way but 2020 was dramatically different. A global pandemic, the steepest recession we have seen for almost 100 years, the first recession in Australia since 1990, rapidly rising unemployment, deserted cities… who would have thought?

And yet, despite all the ups and downs, markets haven't been too bad. Australian equities have returned 3.5% since the beginning of the year, US equities 9.4% and listed property -2.5%. If we had been asleep all year, we may have been tempted to think it had been uneventful.

Of course, it was not in the least. And there have been lots of lessons to learn - or relearn - as a result.

1. Expect the unexpected and stay diversified

As much as we try to anticipate the future, it will always be full of surprises, some good and some bad. While the risk of a global pandemic had been discussed for years, the real thing was still a major surprise. One of Donald Rumsfeld's known unknowns.

The outlook for many businesses has been changed forever, either speeding up a long decline or accelerating a rise. The outlook for office buildings and shopping malls has probably been changed forever. Interest rates are likely to stay even lower than we had previously anticipated.

Some assets have been beneficiaries of the pandemic while others will struggle. Being diversified continues to be an excellent strategy.

2. Markets over-react

This just keeps happening. Investors tend to get overly optimistic during the good times and, even more so, become far too pessimistic when bad news strikes.

The market seems to assume that recessions will last for ever, that industries will never bounce back, and that headwinds and tailwinds will be hurricanes. Often the best opportunities in a crisis are to be found in those areas where the market has the greatest concerns. Commercial property is one such area.

In times of seeming crisis, it really helps to have a long-term perspective where we can sit back and assess likely long-term returns under a range of scenarios. We certainly found this to be a very valuable exercise during the March panic.

3. Responding to well-known risks is a poor investment strategy

This idea has been starkly illustrated this year. Reducing equity exposure in March in response to the unfolding COVID-19 crisis would have been disastrous. We believe inevitably so.

Because markets tend to over-react when bad news strikes, by the time we have a fair idea of the risks we face, the market will have generally already factored those risks - and more - into prices. As a result, responding to known risks is a recipe for selling near market lows.

There is an argument that we are stewards of our clients' wealth and that prudence requires that we reduce risk (that is, sell equities) at times of extreme uncertainty. At times, that argument can seem compelling.

The reality is that if we advised clients to take defensive action every time a significant risk appears on the horizon, we can kiss goodbye to the equity risk premium. Grexit, the PIIGS Euro crisis, the Taper Tantrum, Brexit, Trump, the Bondcano and now, COVID-19, have all been wonderful opportunities to prudently lose capital for clients.

4. Short-term trading is really, really hard

We had some hard evidence of this over the course of this year. The first half of this year provided a rare market timing opportunity. In February, the evidence was mounting that the impact of COVID-19 on the global economy was likely to be very severe. Sharemarkets ignored that evidence for weeks. Markets then severely over-reacted and by late March represented a bargain before rebounding strongly over the second half of the year.

If ever there was an opportunity to engage in some successful market timing this was it. So how did the professional market-timers perform? The latest fund manager performance data showed that the average manager underperformed the index in every asset class over the first half of the year. If there was lots of successful market timing going on, it's not clear from the data. Admittedly, many funds don't attempt to time markets and these results are a mixture of stock selection as well as market-timing. Nonetheless, if this trade was as easy as it seems in hindsight, it should have shown up in the numbers.

5. Humans are both incredibly resourceful and resilient

Globally, the COVID-19 crisis is far from over. Here in Australia, we have found ways to avoid the worst of the health impacts. In many other countries the picture is not nearly so rosy. And yet, with the advent of three likely candidates for vaccines, we can see a time when the world gets back to something approaching normal.

In the meantime, perhaps amazingly, many businesses have adapted. Working from home, zoom and social distancing has kept many businesses ticking over. So much so, that, in the US, quarterly corporate profits are back to pre-COVID-19 levels. In Australia, profits in 2021 are forecast to exceed those of 2019.

Assuming the worst – as markets do when they over-react – flies in the face of what we know about human ingenuity and spirit.

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