PORTFOLIOMETRIX

Discretionary Investment Management for the 21st Century

Hi All,

Maintaining composure in turbulent markets is not easy. Doing so when events take us into unchartered territory tests us all a little more. However, "unforeseeable" events happen more often than we think and the principles for navigating them remain familiar.

The coronavirus outbreak has been described as a Black Swan event.

Coined by scholar and former option trader Nassim Nicholas Taleb, a black swan is an event that, as paraphrased by Wikipedia: "comes as a surprise, has a major effect, and is often inappropriately rationalized after the fact with the benefit of hindsight ".

The term is based on an ancient saying that presumed black swans did not exist – a saying that became reinterpreted to teach a different lesson after black swans were discovered in the wild".

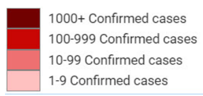
At the time of writing this on Monday afternoon, oil is off over 22% and it's a popular time to discuss Black Swans!

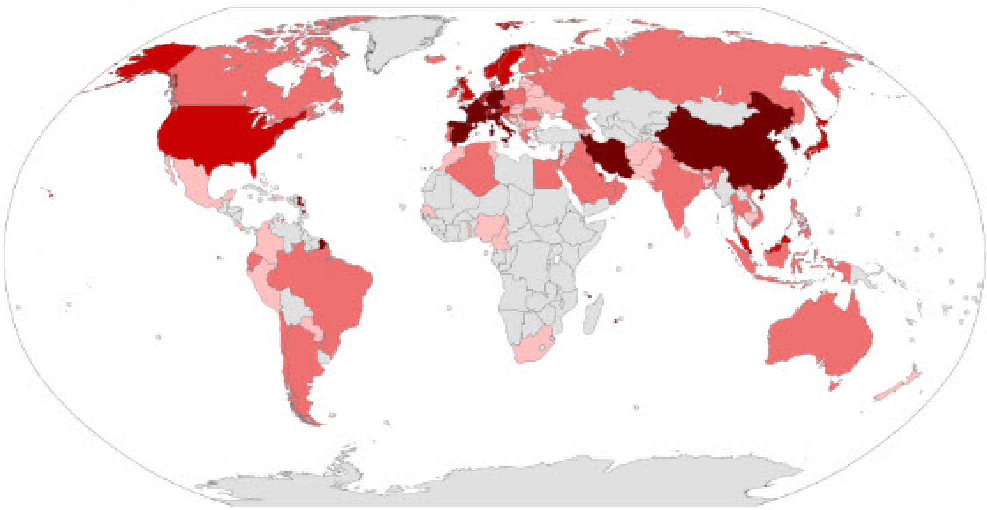
I remember attending a microbiology event in Berlin a few years ago with my wife, who is a clinical microbiologist. Leading virologists and epidemiologists spoke about the certainty of having to deal with superbugs in the future and talked about their characteristics, likely impact and the challenges of containing them. So, this was sort of expected – minus useful information on what, when, where and how big. After the last COVID-19 case is gone, there will be others at some point in the future. They have always been there in our past.

At the conference, the adequacy of public health infrastructure was questioned. Equally important, concerns were raised about the risk of initial apathy and inertia due to mental framing. There is often an inability to correctly appreciate risks that you have no experience of or where one over-relies on historical data. In a nutshell, humans (politicians, investment analysts and doctors alike) have initially behaved as expected but are now learning quickly. We expect this of humans.

**A first time for everything**

I have spoken about data illuminating only one path of an infinite number of possible paths that history could have taken. When anyone says, "history proves", be sceptical. Specifics of "unpredictable" events may be unknown but exist "in potentia" all the time - there was a first time for everything that has ever happened. We should expect unexpected events and neither over-react nor under-react. In practice, investors can expect several Black Swan events in their lives and how they deal with them has everything to do with successful long-term investing.





*Source: WIkipedia*

Map of the COVID-19 outbreak ***as of 7 March 2020***

Many have questioned whether COVID-19 is such a big deal, putting it in the "bad flu" category and pointing out that people die all the time from well-understood diseases. Mortality aside, markets are reacting to the likely economic disruption due to the severity of measures designed to contain the spread. Limiting people from mingling and travelling impacts the global economy, but that may be the right thing to do.

The idea that the virus can be contained in an absolute sense has been debunked and getting that point out of the way is important. The right policy responses and behaviour of people can make a tremendous difference. According to The Economist, China recorded 3887 new cases of COVID-19 on February the 4$^{th}$ and only 139 on March the 4$^{th}$. However, not all countries will be able to mimic China's draconian lock down – but they can avoid the mistakes and learn the lessons from China's failures and successes.

**Why is slowing the spread important?**

Simply, it means that cases are stretched out over a longer period, giving health care systems more time to prepare with less chance of being overwhelmed. Spreading out the infection rate means a more measured response, less chaos and less fearmongering. In SA we have a few advantages, which buys us a little bit of extremely valuable extra time. However, the longer infections are spread out, the longer the pain inflicted on economies.

It has been shown that governments that have been transparent and upfront with information have handled the crisis better, whereas those that have obfuscated, prevaricated or trivialised the risks have done less well – the US being a primary example. Therefore, I will not attempt to sugar-coat the severity of this situation. When the dust has settled and the costs counted, the economic effects of COVID-19 will probably be severe, but caution is required before drawing conclusions.

**It's all about perspective**

Let's think about the price of a share. It is simply an amount of money that seems fair for the earnings of a company, paid out in dividends (or experienced as price appreciation), in perpetuity, which is a long time. We might talk about a share trading on a price earnings ratio of 20. This means is that you are paying twenty times the current year's earnings to buy the share, so what's the problem with one bad year?

If it was as simple as that, then markets would not have reacted as negatively as they have. The other ingredient is uncertainty, which drives prices downwards. Investors simply don't know whether a company will survive or how likely their projections are to be true. But overwhelmingly, companies will survive, but not without pain. It does not take a massive return to profitability to get stocks to rebound, just a little less uncertainty and a bit more clarity.

The key thing for investors to remember is that markets are forward looking. There is no obviously correct response to the news – it has already been incorporated into market prices by people with access to the same new information. Responding "after the fact" to falling or soaring markets is the whole reason why investors tend to do worse than they should. Perfect hindsight is great, and some people get lucky with timing, but studies consistently show that **composure and resisting the impulse to react or overreact is the key ingredient to successful long-term investing**.

The challenge with being tempted to get out of markets when they have sold off is that it imposes another very awkward decision – when do you get back in? If you got out in the first place because of real concerns, you are unlikely to get back in when things are at their most dire (the bottom). More likely, composure returns only after a sustained rebound and risking missing a large part of the recovery carries consequences. Sitting it out by staying invested is tough, and the next few months will be particularly hard, but it's exactly what we need to do.

Kind Regards,

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