

How Best to Weather the Storm

Don't be naively optimistic or sadly pessimistic. Put in place a system to prepare for the worst, but keeping faith that the crisis will pass

by Christopher Tan, CEO Providend

It was a bright and sunny day. You were walking through the jungle and on your way to your objective many kilometers away when without warning, a big storm came raging. But like all good soldiers with only the mission in mind, you walked on, unclear with what lies ahead. As you continue walking, it became clearer what damages this storm has caused to the route. You have now 3 choices:

- a. Continue the same route that has been marked out for you by your reconnaissance team. You may take longer to reach your destination as the storm may have caused fallen trees and other damages. But this route gives you high certainty of reaching the objectives as it is a tried and tested route.
- b. Detour to a new route, it is more open, with lesser obstacles but because it is unmarked, there is a need to navigate and make decisions along the way. You may reach the objective on time if you make more right decisions than wrong ones. But the certainty is unknown because no one has walked it before.
- c. To give up and turn back.

How many times have you face a decision like that? Over the last few months, my team and I had exactly the same dilemma. We were on our way to achieving clients' financial goals with good investment returns when out of the blue, a financial storm hit us. After a while, it became clearer to us that this may not be a normal storm. What damages will it do to our clients' objective and which route should we take? We had to go back in time, starting from 1900 to find out. Data dating this back were hard to obtain. Even with the wealth of information we can find in Bloomberg, we had to make a trip to the library to get everything that we need. My investment team spent many tireless days and nights working on it and this was what we found out: There were 3 of such big storms in history since the 1900: They are the *1930s Great Depression*, the *1970s Stagflation* and *1990s Japanese Deflation*.

The 1929 Depression

After a period of excessive leverage for banks in the 1920s, the stock market crashed in 1929. Banks fell due to debt defaults and massive deposit withdrawals. Plunging asset and commodity prices led to hyper price deflation in the initial years. Dramatic drops in demand led to widespread unemployment and poverty. The government did not inject

enough money into the banking system, creating a shortage in money supply. Banks became extremely conservative in their lending. The government worsened the situation by increasing taxes in 1932. The Dow recovered to the pre-crisis level only in July 1954.

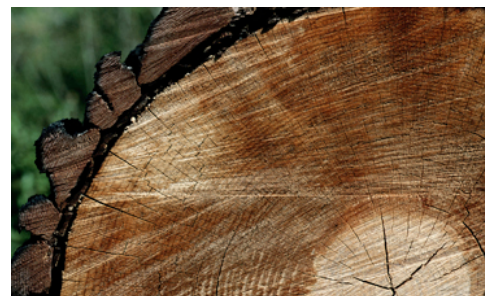
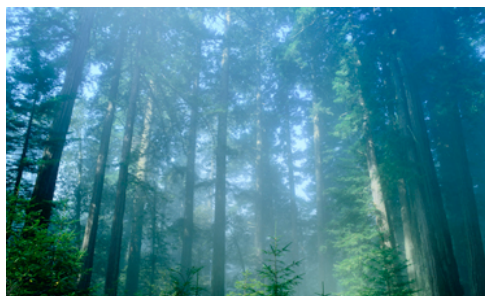
The 1970s Stagflation

In anticipation of price increases, people kept buying more goods. With more demand, wages were pushed up, leading to an upward price spiral. This worsened when oil prices soared during the oil crisis, caused by political tension in the Middle East in 1973. Excessive stimulative monetary policy sparked a runaway wage-price spiral. Government borrowing pushed up interest rates and increased costs for borrowing. Business investment suffered and unemployment rates rose. The Federal Reserve chose to sharply hike interest rates into the double-digits from 1979-83 to tame inflation. This caused the economy to fall into a recession until 1983.

The Japanese Deflation Starting from the 1990s

Loose monetary policy sustained stock and property markets rallies in the 1980's. When the asset bubble burst in late 1989, the government took 3-4 years to increase government spending. Interest rates took almost 9 years to come down to 0 percent. Stock markets and property markets crashed. Property prices declined between 3%-6% p.a. annualized through 1990 – 1998. Banks did not write off losses and the government sustained failing banks and businesses using subsidies, thus prolonging the crisis.

During these 3 periods, equities did badly. Bonds gave decent returns during the great depression and Japanese deflationary period. Commodities did well during the 1970s stagflationary environment. Using the historical returns of different asset classes during these 3 periods, we back tested our diversified portfolios and it became very obvious. Our research showed that in the first 10 years, traditional diversified portfolios were categorized by inconsistent, extremely low and sometimes even negative annualized returns. It was only from the 10th year onwards that returns became consistent and stronger; albeit still lower than what clients will require because of a lost decade of returns. Although returns were high during the stagflation period, inflation was also very high so real returns are nothing to shout about.



	Annualized Back-Tested Portfolio Returns (from 2 nd Year of Crisis to 15 th Year)		
	Balanced Portfolio	Aggressive Portfolio	100% Equity Portfolio
Great Depression	4.0%	3.5%	2.5%
Stagflation*	11.5%*	12.0%*	12%*
Japanese Deflation	4.0%	2.5%	0.5%

Source: Providend

*Although returns were high, inflation were also as high as 8%.

So what are the chances of the current crisis being “a big one” like the above 3? We believe that it is likely as the current downturn is not the usual cyclical one but one caused by much structural problems. There are excessive debt level amongst consumers and institutions. Financial and non-financial institutions are falling like dominoes in a pack. There are much fear in the environment and hoarding of monies. This crisis has also spread all over the world. Just like the jungle situation, we now have to deliberate to make a decision.

Situation 1: You do not have enough time as you need the money very soon. Achieving your original financial goal is not important now.

Decision: Get out of the market now and turn back, you can't take and don't need to take this risk. You need to review your financial plan to see how much you should get out.

Situation 2: You do not have enough time but achieving your financial goal is very important

Decision: Detour and take a new route. The time-tested way of asset allocation, staying invested and riding out the volatility may not work as there may not be sufficient returns in the next 10 years. The new route entails navigating through this crisis, making decisions on which asset classes to be in. This is not a tested route, but you have no choice, you don't have time unless, you are prepared to delay your financial goal. If we are in a stagflation scenario, you need to review your financial plan to make necessary changes.

Situation 3: Have more than enough time or can delay the time in achieving financial goal

Decision: Continue with the current route of asset allocation, keep investing, ride the volatility. Although it takes a long time to reach your goal, this is the most tried and tested route. You will achieve your goal with high certainty as 100 years of history has shown us. However, you must be prepared that the returns will be lower than what you originally expected as

it is hard to catch up after a decade of lost returns. You need to review your financial plan to make necessary changes.

So what if we are wrong and this is just a normal downturn and will recover this year like what a lot of optimists are predicting? In the 1930s, the US government, scholars such as Irving Fisher and businessmen such as Henry Ford predicted an early recovery. They were humbled. In the mid 90s, the US government including Alan Greenspan, Robert Schiller from Yale forecasted an unsustainable bull run; the market ran for 13 years till 2000. No, we are not going to be in the business of prediction. That's gambling. Neither are we going to be naively optimistic or sadly pessimistic. We are in the business of putting in place processes to prepare for the worst but keeping faith that this crisis will pass, like all others. You will quickly realize that, if a fast recovery comes, we will not be worse off then if we have not made a decision.

Ever since our research and especially at the dawn of 2009, I became especially burdened by the advice our industry has been dishing out. Many are telling that 2009 will be a happy year. Stockbrokers are saying this is the best time to trade stocks. Property agents are telling everyone to buy property, financial experts are asking everyone to stay invested, keep investing, ride the volatility and things will pan out. I must admit I was guilty of it too, before our research that is. Some are predicting where to put our money in 2009, as if we are only investing for a year. I just hope all of us are not selling our wares just to keep business going. During the Vietnam War, many US POWs died at prison camp “Hanoi Hilton” because they all hoped and believed that they will get out by Good Friday, Easter, Thanksgiving, Christmas Day. But when these came and gone, soldiers died with a broken heart. Jim Collins wrote in his book “Good to Great” that one man by the name of Admiral Jim Stockdale survived because he never predicted when he will get out but lived each day “confronting the brutal facts” and yet retaining the unwavering faith that he will live to see light again.

Napoleon Bonaparte once said: “Take time to deliberate, but when time for action has arrived, stop thinking and go in”

We have deliberated. The time has arrived. We now know which route to take. We are going in.

This is an original article written by Christopher Tan, CEO of Providend, Singapore's sole fee-only Independent Private Wealth Management Firm. The edited copy appeared in The Business Times Weekend 31 January - 1 February 2009.