In Perspective

China and the Global Equity Market Turmoil

August 2015

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The worry and avoidable wealth destruction which accompanies times like these makes taking a look at – and a step back from – recent events worthwhile.

What seems to be the problem?

Specific events – in this case a falling Chinese equity market, coupled with a broader reassessment of the prospects for the Chinese economy – often act as a trigger for a major movement in global equity markets. Indeed, that is how equity markets work; the current value of the markets reflects the aggregate of the estimated current value of firms within it, based on the market's view of their future earnings.

Markets move when new information becomes available; if this news is bad for company earnings, markets will fall; if it is positive they will rise. In this case, the Chinese government's ham-fisted, desperate attempts to shore up the Chinese equity market, combined with its recent devaluation of the Yuan, was taken by the market as a sign that the Chinese economy – which represents around 15% of global GDP – was perhaps slowing at a faster rate than was previously thought.

Bursting of the Chinese equity market bubble

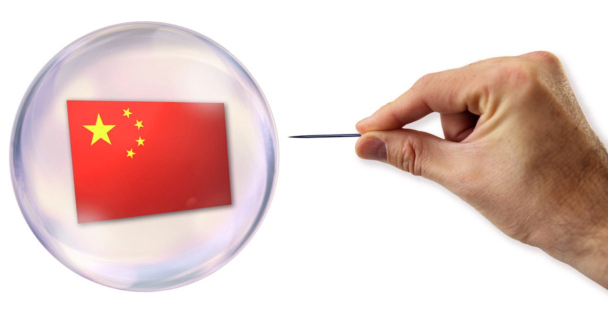
The Chinese equity market (MSCI China Index) rose dramatically by over 70% during the 12 months to May this year, fuelled by rampant speculation; in the last week of May alone, 4.4 million online retail brokerage accounts were opened! Chinese investors had borrowed a record US$232 billion to invest in the market (which is not generally a strategy even a wealthy and/or very risk tolerant person would deem sensible) and the subsequent fall that we have seen has simply given back the previous rampant and unrealistic returns.

For those less familiar with investing, the natural and understandable temptation is to panic in the face of the uncertainty, the fear that accompanies headline-grabbing news reports (the BBC's Robert Peston seems to love the drama of any market turmoil) and the worry about what is happening to their hard-earned assets.

Keeping events in perspective

There are some important things to remember at times like these:

- Market gyrations are an inevitable consequence of owning equity assets; markets go up, down and sideways over time. As such, two steps forward and one step back is a reasonable way to think about owning equities. Indeed, experienced investors will realise that it is the very uncertainty (risk) of short-term market returns that delivers the longer-term incremental returns that equities offer, above owning bonds or cash.
- In investing, you do not make a financial loss unless you sell out of a position e.g. selling equities when they are down. As a long-term investor, you have the luxury of being able to hold your assets until the storm passes.
- The allocation to equities in your portfolio is linked to your emotional tolerance for risk, your financial capacity to suffer periodic falls in value and your need to take on risk in order to pursue your financial objectives. Most investors own a balance between bonds and equities and accordingly, you should remember that your portfolio will not have suffered anything like the headline falls of the Chinese market!



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- You own a well-diversified portfolio made up predominantly of developed market equities and high quality bonds and your direct exposure to the Chinese market will be very small (probably less than 2%).
- The high quality bonds that you own will be undertaking their defensive duties at this time. For example, since the start of August 2015 to the time of writing (25 August 2015), global high yield bonds (those with higher credit risk, which you do not own in your portfolio), have fallen by over 2.5% (Barclays Global High Yield Index), while the developed equity markets (MSCI World Index) have fallen a little over 10%, as has the UK market (FTSE All Share Index). Meanwhile, your short-dated bonds have risen by 0.72%, so what is often the most 'boring' constituent of your portfolio has been your best friend in recent times.
- The UK market was last at its current level as recently as mid-December 2014, but few were alarmed at that time as the market was gradually rising. In fact, even with recent falls, the UK market is up around 45% over the past 5 years and global developed markets are up around 60% over the same timeframe. We need to keep these short-term events in perspective.
- The US and UK economies are growing strongly – it is not all doom and gloom.
- Depending on how far your portfolio's allocation has changed, it may be sensible to think about rebalancing your portfolio by selling some of your high quality bonds and actually buying more equities to return the portfolio back to its original structure (we will, of course, contact our clients in advance of our annual planning meetings together, if we feel that such a move may be especially warranted).

Remember, investing is a long-term game and once you realise that neither you nor anyone else can control the markets – and that knee-jerk decisions almost always result in the wealth destruction strategy of buying high and selling low – then what you have left is what ultimately matters; namely structure, patience, discipline and the comforting evidence that time heals most investment wounds.

In summary, it is perhaps worth reflecting a while on the wise words of Charles D. Ellis in his excellent, classic book, Winning the Loser's Game (Ellis, 2002):

'The hardest work in investing is not intellectual, it's emotional. Being rational in an emotional environment is not easy. The hardest work is not figuring out the optimal investment policy; it's sustaining a long-term focus at market highs or market lows and staying committed to a sound investment policy... particularly when Mr Market always tries to trick you into making changes.'

His wisdom continues:

'Don't trust your emotions. When you feel euphoric you're probably in for a bruising. When you feel down, remember that it's darkest just before dawn and take no action. Activity in investing is almost always in surplus.'

As ever, we will remain vigilant on your behalf and keep you posted as required, but in the meantime, all you need do is keep calm and remember two things: that you always knew the day would come when your emotional resilience would be tested and that your portfolio, while not being able to defy gravity and shelter you completely, was also structured in anticipation of days like these.

Best regards

Michael

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In addition to being a Chartered Financial Planner, Michael holds the globally recognised Certified Financial Planner qualification and is a Fellow of the Personal Finance Society. Michael also sits on Chamberlyns' Investment Committee and produces the firm's regular series of concise 'In Perspective' articles, which consider, and provide perspective on, a range of current and timeless wealth planning issues.

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