Professional Capital

Advising Professionals Every Step of the Way

Charting your Financial Future

What Should You Do When Asset or Market Prices Are Falling?

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Introduction

The reality is that asset prices will go up and down over time. There is no 'if' about it.

In most other areas we are delighted when prices fall.

Take fuel prices at the pumps for example, we feel good when we see the price falling and bad when we see them rising.

The temptation was to call this guide "What should you do if asset or market prices are falling?"

But that one-word difference would have presented a deception.

The reality is that asset prices will go up and down over time. There is no 'if' about it. Indeed, we should want prices to go down – some of the time.

Falls in asset prices and values are to be expected, normal and healthy as part of the longer-term journey.

Ironically, these normal movements, which can span years, probably prevent more calamitous 'crashes' which can come from market rises which over-extend.

What is an 'asset'?

For the purposes of this guide we will focus on and define assets as investments that are purchased and held with an expectation that the asset will provide income or will later be sold at a higher price for a profit.

The investment assets/sectors we will focus on are:

- Fixed Interest – such as corporate bonds, government bonds and similar, both in the UK and Overseas
- Equities – basically, shares in companies in the UK and Overseas, both small and large companies
- Property – this includes residential and commercial property – both UK and Overseas
- Commodities – oil, gold, coper etc.

Investment assets present a difficulty for many investors, because there is often a psychological factor involved which is quite distinct from most people's normal experience.

In the shops we hunt for bargains and like it when we see the price of our favourite items lower than normal.

We are conditioned to enjoy lower prices.

This gets challenged when we invest or hold an asset.

If our asset price lowers we can easily get unnerved, worry about it and wonder where this is taking us.

This shows up most commonly with investment into shares, which tend to move up and down more rapidly than property and sharper – in both directions – then fixed interest investments.

Commodities, on the other hand, are like shares, their prices also tend to fluctuate with significance.

The gut reaction of many private investors is to sell their shares quickly in a falling market to avoid incurring further losses. However, this is often the worst thing one can do.

Here are some reasons not to sell in haste:

1. Historically, falls in share prices, even significant falls caused by stock market crashes, level out over time. For example, the FTSE All Share Index was back to the level it had reached before the crash of October 1987 within 2 years and had more than doubled its pre-crash value within 10 years.

2. Long-term strategies and investment decisions should cope with a falling market, as the likely reason for falls is a lack of confidence amongst investors not a fundamental problem with an investment or fund or company.

3. Losses change from “paper losses” to “realised losses” only when you sell your shares, if the sale occurs after a rapid fall or when prices are low history shows this is almost always the worst time to cash in. As prices tend to recover a better time to sell, at a higher price, will arrive.

4. Panic selling has a knock on and, potentially, self-perpetuating effect. If investors as a group can work through the down periods, there is less likely to be widespread cranage and prices can revert to a more reasonable level.

Although these aspects are cited as relevant to the more volatile areas, such as stock markets and shares, the principles span most asset areas.

This fear is far from irrational. Such future pathways do exist as possibilities. The problem we have is we cannot accurately measure future possible outcomes.

The experience in Japan over many decades suggests that this is not a possibility that should be lightly dismissed.

How Can We Be Sure That Any Falling Market Isn't "The Big One"?

The big fear amongst investors is that any market falls become steep and sustained. That we enter a period the like of which we have never seen before or not for a very long time.

Of all the possible future returns that exist we have no real idea how probable each one of these might be. The default option is to turn to historic evidence and work around this.

That gives much comfort because history shows that real assets trend upwards over time and falls are less likely than rises over most reasonable periods, i.e. terms of five years or longer.

History shows that falls – when they occur – tend to be compensated for by larger rises later down the line. However, that is the historic position and the assumption in looking forward using the historic view is that similar-type outcomes will occur in the future.

The real challenge for investors would come if there was any break from the historic pattern, an example would be a steep fall in an asset price or market, followed by another steeper fall with no short or medium-term recovery following on.

Specifically, as an example, imagine an asset falling 20% next year. Followed by 30% the year after and then flat lining for the ten years after that. How would that impact you? How would that make you feel?

Such a scenario would upset the plans and positions of many investors, if that related to a big proportion of their overall assets.

The difficulty here is that any falling market could be the beginning of something like this. You would only know in the far future with the benefit of hindsight. More likely, it would be a normal falling market which recovers relatively quickly.

If every time the market fell 20% you bailed out to wait and see what happened, you would -based on historic evidence – be making a massive error, selling low and being forced to buy high, if you wanted to re-enter the market later down the line.

That is why all the evidence leads to the advice, which is to hold firm and to ride out the inevitable downturns from time to time.

The Paradox

You will spot that this does lead to a paradox.

You will quite rightly want to avoid 'the big one' if it comes along, that steep and sustained downturn that could ruin your best laid plans, but you cannot jump ship every time there is a wobble or short-term fall.

Therefore, the right thing to do is to stay with a falling market, but that is the wrong thing to be involved with if it turns into something nastier.

Many investors deal with this paradox in a very particular way.

They ignore it and take the risk, feeling like it is a small risk (which is probably correct, although we can only determine it is a small risk based on historic evidence, we have no future evidence).

Some other people avoid this risk by not investing at all or investing only a fraction of their available sums and keeping the rest in ultra-safe havens, such as bank accounts and sacrifice the future returns they may get from real assets. This is trading the risk against future returns.

Then there is another route, a middle ground and this is where the paradox can really be tackled at its most efficient.

This is the stress test route and we would advise you to follow this as the best and most financially prudent way.

The Middle Ground

What is this so-called middle ground way or method? It is to use an active and well-structured asset allocation approach.

The approach is simple in theory and not much more complicated in practice. That is to find the right mix of asset areas and to create a diversified portfolio.

The theory is based on the understanding that different asset areas perform in different ways at different times. So, when one asset area (or sector) is doing badly, another is doing well.

For example, a typical portfolio might look something like this:

- UK Shares **20%**
- Overseas shares **15%**
- UK Fixed Interest **20%**
- Overseas Fixed Interest **10%**
- Property **15%**
- Commodities **10%**
- Cash **10%**

The asset allocation approach should be active to be truly successful long term. It is crucial to explain what this means – as the word 'active' can be used in other contexts as well.

Active in this context really means dynamic and must be understood as attached to the words 'asset allocation', we are therefore describing 'active asset allocation' or 'dynamic asset allocation'; this means that you follow the basic principle of an asset allocation and you rebalance regularly.

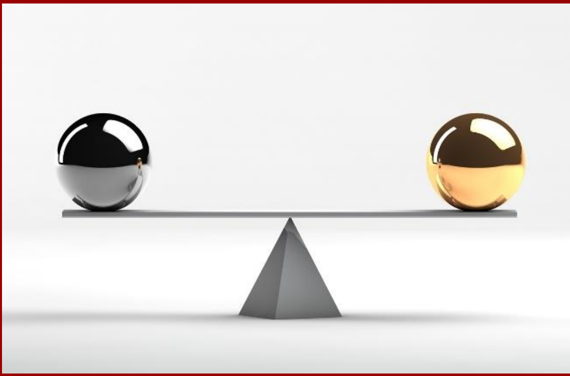
Rebalancing makes the approach active.

How does rebalancing work?

It is the regular adjustments you make to your portfolio to keep the mix of assets in line with your attitude to investment risk over time. It may also take into account wider economic movements, but it is mostly about the portfolio shifting because of performance.

Imagine that the portfolio example above moves from its original structure shown, because of market movements in the asset prices, so that it becomes, after some time:

	Original Mix	Mix after a few years of diverging performance in the asset areas
UK Shares	**20%**	**17%**
Overseas shares	**15%**	**13%**
UK Fixed Interest	**20%**	**24%**
Overseas Fixed Interest	**10%**	**12%**
Property	**15%**	**12%**
Commodities	**10%**	**7%**
Cash	**10%**	**15%**



Rebalancing

Rebalancing is the process of regularly moving the assets back towards their optimum position as required.

Title

The investor hasn't changed anything, the asset prices and values have moved because of performance. They are no longer taking the same approach as originally selected.

Rebalancing is the process of regularly moving the assets back towards their optimum position as required. In the example above, the investor would rebalance by reducing their cash and fixed interest holdings and shifting more back into shares, property and commodities.

This would be a way of disciplining the approach to selling bits from those areas that have done relatively well and topping up those areas that have done relatively poorly; which increases the prospect of buying low and selling high.

It helps to keep the risk level managed and produces, in the longer-term, an in-built discipline to the investment structure.

Therefore, investors who use this approach tend to feel more relaxed when asset areas are falling as they know that sooner or later they will rebalance, and this could help with better longer-term returns.

The only difficult questions amongst all of this for investors are "what my correct asset allocation position at any time is?" and how often should I rebalance?".

We can help you with answering both questions. As this is what we do within our advisory work.

Diversification

The main attribute of diversification is **reducing risk.**

The objective in these cases is to mix the portfolio of assets you hold to lower the risks you face, as described in the section above.

There is often a confusion that asset allocation is about the upside, finding the right balance of assets to capture the best returns. **This is not correct.**

For example, if you considered UK shares a better prospect of future returns than UK property you would invest purely in UK shares. If you had no idea of the prospects for either you would invest a proportion in each, logically 50/50. That 50/50 split has no prospect (0%) of being the best return.

If this was the case, then an asset allocation strategy would always be geared towards investing 100% in one asset as that would represent the best chance of getting the highest return.

Diversification

Diversification and an asset allocation approach towards this are inherently risk reduction techniques. They can help defend against the sort of doomsday scenario described above and go a long way towards handling the paradox mentioned.

Why Not?

Think of it like this, if UK shares rise 20% and property 10%, then the 50/50 split would produce 15%. 5% less than investing 100% in shares.

If it was the other way around then you would still get 15%, but you would have done better investing 100% in property.

Using an asset allocation approach will always reduce prospects of maximising the greatest possible return. It is an exercise with the value all in the risk reduction mechanism it offers.

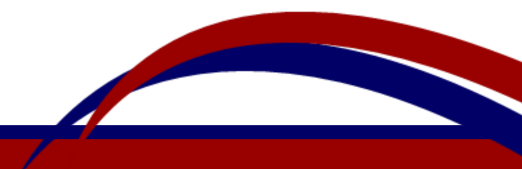
If using our example as above you saw UK shares fall 20% and property rise 10%, overall you would lose 10%, you have avoided the worst possible loss (which you would have incurred by investing all in UK shares).

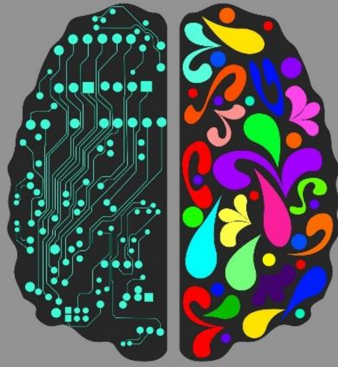
The benefit of asset allocation increases the more you spread this position across different asset classes. The examples above are 50/50 positions, but if you have variable asset classes, that are considered 'non-correlated', then the risk reduction improves.

Non-correlated means that on all known evidence the assets are unlikely to move in the same direction at the same time. They are not inherently linked in any way by close technical associations.

Typically, fixed interest, shares, commodities and property, especially where relevant split even further across geographical divides and sub-assets (e.g. small companies, large companies), move in different ways over time.

Their price movements tend to work differently, even though at times, there may be concurrent falls and rises in each.





Emotional and Behavioural Considerations

We all react in certain ways to certain events and make decisions driven more by our emotions than we would probably realise.

This is probably a subject worthy of its own guide.

However, to summarise a little here, the science behind emotional and behavioural finance has started to reveal how important these are in the approach to money management and investing.

We all tend to react in certain ways to certain events and make decisions driven more by our emotions than we would probably realise.

Examples abound, but in terms of market falls, investors can become gloomy or panic and start to behave differently. This can include making irrational decisions to sell out (often at the worst possible point) or even more significantly, suddenly believe they can sell and then buy back at a 'better time'. On this latter point the evidence is clear and consistent – investors fail at this (overall).

Rarely do investors relax when their portfolio value, or a part of it, is falling. Nor do they welcome this. Yet – rationally – if such an event is normal and to be expected then what difference does it make?

The biggest challenge with investing tends to be the longer-term aspect. Measurements must be made, and results judged over long periods. In the moment this can be difficult to maintain.

Even two years can seem like a long time when markets are falling. Yet, in investing terms, two years is short-term.

Rational investors realise this and will simply accept the down times as normal periods, that are inevitable.

More than this they will see this as an opportunity to keep a close eye and when the time is right rebalancing for their longer-term benefit.

Conclusion

It is not easy being a rational investor!

Conclusion

The emotional angle covered in the previous section is a natural one, as we all want to enjoy our lives and avoid difficulties. When investment values are falling we can easily allow our minds to project into the future and foresee difficult or uncomfortable outcomes.

The iron discipline and unemotional characteristics of a professional investor are difficult to learn or absorb. However, there is likely to be much less stress and, in practical terms, a better outcome by adopting this approach.

Rationally it is wise to expect and then relax about asset price or market falls. If the basic investment position you have chosen is built upon strong foundations, then there is no reason to worry, panic or leap into action.

There should always be regular reviews and it may be that if a prolonged or unexpected fall occurs a review is made to explore how this affects any of the plans and – possibly – if this gives rise to any fresh opportunities?

The history of asset markets and price movements in those markets show that they fluctuate and there have always been periods when prices have fallen, these are part of the normal cycles and should pose no threat to any investor.

Provided the investor has a well-structured risk position.

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