

A Brief History of How to Lose Money

– Richard Stutley, CFA

With global equities on track to deliver their best-ever month, against a backdrop of the deepest recession since the Second World War, investors are understandably questioning whether markets have come back too far and too fast. Valuations appear rich in certain areas but trying to time the market is notoriously difficult and can lead to disappointment. At times like this it is worth reflecting on the common ways in which investors suffer permanent impairment of capital as opposed to short term fluctuations in the value of their investments. While the history of finance is long and varied, three factors appear time and again in this regard: counterparty risk, leverage and liquidity. This is a good place for investors to start when appraising risk in their portfolios.

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Your counterparty is whoever holds your money, be it an individual, a company, a fund or a country. Given that exposure to a counterparty is a feature of most investments, it only becomes a risk when investors have too much exposure to one counterparty. Things can go wrong for a variety of reasons: while cases of fraud – from Barings Bank, to Enron and more recently Wirecard – receive the most attention, by far and away the most common reason for your counterparty reneging on their obligations is that things simply didn't work out as planned.

The answer to this risk is to be diversified: give money to a number of different counterparties and accept that some won't pay it back. Also evaluate what residual value there is in your investment if things go wrong. If the only residual value is inventory – i.e. there are no durable assets in the business that can be repurposed – then be prepared to get back very little of your original investment should things not work out.

The next two risks – leverage and liquidity – are ultimately about the same thing: being forced out of your investment and into cash at a poor price, commonly referred to as a fire sale.

Asset prices display excess volatility which means they overreact to new information. Often this overreaction sees asset prices fall significantly below fair value. While these instances of mispricing typically resolve themselves in time, meaning investors ultimately only suffered a loss on paper, the danger is that investors are forced to sell at these depressed prices and therefore do not participate in the asset's subsequent recovery. For example, an investor in the S&P500 index would have lost 20% of their stake from the start of 2020 if they had been forced to sell at the end of March; that same investor would have instead made 1% if they had been able to hold on to their assets another three months until the middle of July; and 14.5% to Black Friday.

Leverage means debt and debt must be serviced regularly and eventually repaid. These obligations can often only be satisfied by selling assets. Hence leverage may come at a greater cost than simply the interest charge on the borrowing, if it precipitates a fire sale. Given that the golden rule with liquidity is never to need it – i.e. avoid the situation where you have to sell an asset to meet a payment – it is clear why leverage and liquidity go hand-in-hand and need to be carefully monitored.

There are prudent steps investors can take to manage their liquidity. Most importantly, understand how long it takes for transactions involving your asset to complete, and what the average transaction size is: don't expect to be able to sell your asset more quickly or in greater size than the average deal, without offering a discount.

In sum, history shows that appropriate diversification is the first step to protecting one's wealth. Secondly, try and minimise the chances of being forced out of one's assets and into cash, due to excessive leverage or else liquidity needs. Taking note of these lessons from history is not guaranteed to safeguard investors' wealth but it may prevent them from losing money in some of the more common ways.

The Marketplace

- Global equities rose +2.4% last week on the back of further positive vaccine news
- The Oxford/AstraZeneca vaccine has been shown to have a high efficacy rate, though this will be subject to further testing
- Brent crude rose +7.2% ending the week at \$48.2 a barrel
- Gold fell -4.4% to end the week at \$1787.8 an ounce

Market Focus

US

- The large-cap US equity benchmark returned +2.3% over the week
- President Trump has said he will relinquish power if the Electoral College confirms Joe Biden's win in the presidential election
- President-elect Biden is reportedly planning to nominate former Fed Chair Janet Yellen to serve as Treasury Secretary
- The composite PMI rose to 57.9 in November from 56.3 in the previous month
- The Conference Board's consumer confidence indicator fell to 96.1 in November from 101.4 in October and below expectations of 98
- Weekly initial jobless claims for the week ending 21st November rose more than expected to 778k
- New home sales fell month-on-month to an annualised rate of 999k in October, above forecasts of 970k. This was a decrease from the previous month's reading of 1,002k
- The VIX volatility index fell to its lowest closing level, 21.3, since late February.

UK

- UK equities rose +0.3% on the week
- The UK's composite PMI fell below 50 to 47.4, against 42.5 expected

- The government is reportedly looking to fiscally consolidate as the OBR forecasts that the budget deficit will reach a peacetime record
- Brexit talks have progressed on the three problem areas of fisheries, governance and a level playing field, though significant discussions are still due to take place.

Europe

- The main continental European equity index returned +1.3% last week
- The Euro Area composite PMI fell to 45.1, against 45.6 expected. This is the first time it's fallen below 50 since June
- The composite PMI in France sunk to 39.9 and Germany's reading was 52
- The headline German IFO Business Climate indicator fell for the second consecutive month to 90.7 in November, against 90.2 expected
- Minutes from the ECB's meeting in late October showed increasing concerns about the economic outlook and discussions on taking policy action in December.

Asia/Rest of The World

- The global emerging markets equity benchmark rose +1.8% last week
- Australia's composite PMI reading last month was 54.7 against 53.5 expected
- Sinopharm, a leading Chinese vaccine developer, has applied to bring its Covid-19 vaccine to the market, after it already has been given emergency use and reportedly administered to thousands of people so far.

Asset Class/Region	Currency	Currency returns			
		Week ending 27 Nov. 2020	Month to date	YTD 2020	12 months
Developed Market Equities					
United States	USD	2.3%	11.4%	13.9%	16.9%
United Kingdom	GBP	0.3%	14.9%	-14.4%	-13.0%
Continental Europe	EUR	1.3%	15.0%	0.5%	1.6%
Japan	JPY	3.4%	13.1%	6.2%	7.0%
Asia Pacific (ex Japan)	USD	1.6%	11.4%	17.3%	22.3%
Australia	AUD	1.0%	11.6%	1.5%	-0.8%
Global	USD	2.4%	13.6%	12.0%	14.8%
Emerging markets equities					
Emerging Europe	USD	2.5%	25.0%	-19.4%	-14.0%
Emerging Asia	USD	1.6%	9.9%	22.6%	29.1%
Emerging Latin America	USD	3.6%	24.2%	-21.5%	-12.7%
BRICs	USD	1.5%	8.5%	14.5%	21.9%
China	USD	1.1%	5.7%	29.6%	38.0%
MENA countries	USD	1.4%	7.8%	-3.4%	2.2%
South Africa	USD	1.4%	14.5%	-9.5%	-1.7%
India	USD	1.0%	12.3%	3.7%	4.3%
Global emerging markets	USD	1.8%	11.6%	12.5%	19.5%
Bonds					
US Treasuries	USD	-0.1%	0.4%	8.7%	8.0%
US Treasuries (inflation protected)	USD	0.3%	1.0%	10.1%	10.1%
US Corporate (investment grade)	USD	0.1%	2.6%	9.2%	9.5%
US High Yield	USD	0.6%	3.9%	5.0%	7.1%
UK Gilts	GBP	0.5%	-0.3%	7.5%	6.2%
UK Corporate (investment grade)	GBP	0.8%	2.1%	7.2%	7.4%
Euro Government Bonds	EUR	0.0%	0.2%	5.0%	3.9%
Euro Corporate (investment grade)	EUR	0.1%	1.1%	2.7%	2.5%
Euro High Yield	EUR	0.7%	4.1%	1.4%	2.6%
Japanese Government	JPY	-0.2%	0.1%	-1.0%	-1.6%
Australian Government	AUD	-0.2%	-0.4%	4.8%	2.4%
Global Government Bonds	USD	0.2%	1.4%	8.5%	8.6%
Global Bonds	USD	0.3%	1.8%	8.1%	8.7%
Global Convertible Bonds	USD	1.5%	7.3%	20.2%	23.4%
Emerging Market Bonds	USD	-0.1%	4.3%	5.2%	7.9%

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Property					
US Property Securities	USD	0.0%	12.2%	-10.3%	-11.4%
Australian Property Securities	AUD	0.9%	14.0%	-6.5%	-12.1%
Asia Property Securities	USD	1.0%	14.8%	-9.1%	-5.7%
Global Property Securities	USD	0.9%	13.6%	-9.0%	-7.8%
Currencies					
Euro	USD	0.9%	2.7%	6.5%	8.7%
UK Pound Sterling	USD	0.3%	2.9%	0.4%	3.4%
Japanese Yen	USD	-0.2%	0.6%	4.4%	5.2%
Australian Dollar	USD	1.1%	5.3%	5.2%	9.1%
South African Rand	USD	0.6%	6.8%	-8.3%	-3.1%
Swiss Franc	USD	0.7%	1.3%	6.8%	10.5%
Chinese Yuan	USD	-0.2%	1.7%	5.9%	6.9%
Commodities & Alternatives					
Commodities	USD	2.9%	11.0%	-12.1%	-9.0%
Agricultural Commodities	USD	1.0%	6.7%	10.2%	15.3%
Oil	USD	7.2%	28.6%	-27.0%	-24.8%
Gold	USD	-4.4%	-4.8%	17.4%	22.8%
Hedge funds	USD	0.3%	2.7%	4.1%	5.4%

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