Market correction: what you can do to survive the storm

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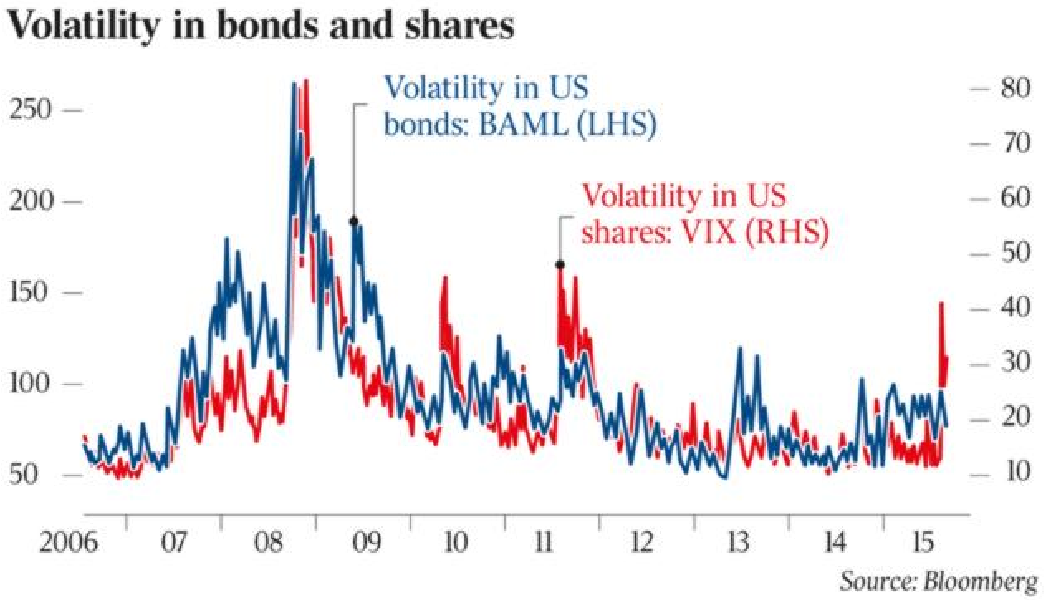

Market volatility. *Source:* TheAustralian

The current turbulence in sharemarkets has many features seen in other bouts of market instability but also some aspects that are very different.

● Occasional periods of intense volatility are a recurring feature of investment markets; they result from investor sentiment becoming single-themed and intense. When the majority of passengers move to one extremity on a ship — starboard, port, bow or stern — the vessel tilts or tips.

These unpleasant wobbles and uncertainties in prices of “risk assets” are why shares pay an -attractive average rate of return over the long term — of something like 7 per cent a year after inflation and before tax.

● This burst of turbulence in investment markets has global causes and global consequences. It began with heightened concerns about the Chinese economy following the crash in local share prices, and was renewed by weak statistics on China’s manufacturing activity.

The turbulence spread quickly around the world and was especially pronounced in the US, where shares in blue-chip companies such as General Electric and JPMorgan Chase at one stage dropped by more than 20 per cent in a few hours. For once, the Australian sharemarket has been less volatile than the US market in a time of mayhem.

● Most periods of intense volatility cause investors to panic. This time around, the panic persisted — despite a significant upgrade to US growth, a (modest) further improvement in the European economy, and clear prospects that short-term interest rates would remain at historically low levels for an extended time.

Some investors capitulated, even in the US where a Chinese slowdown would have a limited direct effect on the economy. One morning recently, exchange traded funds holding blue chip US shares dropped in price by more than a quarter soon after the opening bell was rung — while the S&P 500 index those ETF funds are meant to track fell by 5.3 per cent.

As Barron's, a US investment weekly, explains: "Many small investors caught using orders to sell at market prices could have been toasted … Market makers, who earn a living by keeping EFT prices in line with stocks, held bid-ask spreads extremely wide; sellers were stuck with unusually low bids".

● In periods of turbulence, investment markets often move further than the fundamental influences on them would seem to require. It takes courage to invest in extreme gloom, but there also may be opportunity to buy shares in good companies at attractive prices. My fellow director at QV Equities, Anton Tagliaferro, advises a "focus on the big picture — stable earnings, sustainable yields — as this is generally where everyone will head once the storm subsides ... which it will".

● Often, volatility in one part of the financial market quickly affects other asset classes. This time, though, the impact of turbulence in share prices on bond markets has, at the time of writing, been small and fleeting.

To quote Barron's again: "Bonds failed to benefit substantially from the mayhem in risk assets. Typically, their prices soar during times of turbulence, sending their yields sharply lower."

● Usually, the gloom and worries created for the world economy from sharp falls in share prices drive down the prices of industrial commodities and energy. Not this time: the prices of iron ore and oil for a time had, at time of writing, jumped by a quarter.

● It is market perceptions and sentiment that mostly drive investment markets at times of high volatility — and not the hard facts.

Investors have worried about a hard landing for the Chinese economy for five or six years, as a property bubble built up and then burst. Recently, and just as signs were appearing of a modest but widespread upturn in house prices in the big cities of China, investors' concerns shifted to the collapse in China's sharemarket.

Ashley Owen of Philo Capital has been pointing out for years that "share prices (in China) have little to do with company fundamentals or the underlying economy".

Alas, a market in panic has no time to consider complexities — or even to recognise shades of grey, no matter how compelling.