



Reflections on a Red October

Gard's investment team grapples with market movements as does any other institutional investor. Our Senior Investment Risk Analyst, Thor Abrahamsen, shares his thoughts about current market volatility.

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*The butterfly effect: Metaphorical example coined by Edward Lorenz wherein the details of a tornado (the exact time of formation, the exact path taken) being influenced by minor perturbations such as the flapping of the wings of a distant **butterfly several weeks earlier.** *

Wikipedia

October was a difficult month for the financial markets, with most equity markets falling in value, leaving the world equity index down -7.42% for the month. In fact, the only major market that was up in October was Brazil, where markets greeted the latest entrance of populism in global politics with a cheer. Interestingly, or rather worryingly for many investors, the most important global interest rate measure, the yield of the US 10-year government bond, increased. Over the last 20 years interest rates have tended to fall in response to falling equity markets, increasing the value of government bonds and offering a degree of protection to investors. This relationship, initially sprung from the US Federal Reserve's reaction to the 1987 stock market crash, became more persistent and common market "knowledge" after interest rate cuts in response to the Russian crisis in 1998. Thus, investors would see government bonds as the perfect hedge for their riskier equity positions. However, as interest rates rise, alongside ever-increasing supply of government bonds, this relationship has become less reliable. If this shift persists, it has the potential to turn 30 years of financial risk management on its head. Time, as it is prone to do, will tell.

Gard's portfolio was moderately negative for the month, though it outperformed its benchmark. This relative performance versus the benchmark was primarily down to our portfolio being positioned defensively with a smaller allocation to equities and credit, as well as positive contribution from our tactical allocations.

After a month like October, there is no shortage of people who want to tell us the *why, when, what* and *where* of the markets; *why* it happened, *when* they predicted it, *what* happens now and *where* we should have lunch. Alas, they will mostly be wrong.

The global financial market is a fantastically complex system, made up of innumerable decisions and interactions between corporations, central banks, logarithms, computers and investors (or chaos, if you like). In any such chaotic system, change is often random and cascading, with changes in one part of the market having the potential to cause massive dislocations on the other side of the world. Or not. That is the nature of chaotic systems, we simply cannot know, and determining *causation* becomes an almost impossible task, especially as behind most decisions and interactions lies that most fickle of creatures, human emotions.

Behind the façade of spreadsheets and rational analysis, professional investors remain human, and subject to the same whims and mental traps as the rest of us. Investors approach uncertainty in the same way everyone does - through a *narrative*. Stories are used to form an explanation of things we do not and cannot know and to help us face an unpredictable future. This is the role of media and commentators in the financial markets, to help us form a narrative that gives us the comfort of knowledge where truth is far too complex.

While the *why* and *what* are per definition unknowable, what we can do is to take a step back and evaluate our perspective. Short-term market moves are close to randomness, yet the long term will be influenced by the fundamentals underpinning the markets and the global economy. Exactly *what* these impacts will be, or indeed *when* they will materialize, remains impossible to know. As long-term investors and stewards of capital we can only try to determine where markets offer value and whether we are adequately compensated for the risks. In reality, investing is more a game of preparation than action and it is the process that creates value, not the chasing of shorter-term ebullience or reacting in panic.

After a very strong period for equities the last few years, equity markets are expensive, especially in the United States. Priced for perfection, they imply strong growth going forward, both for the wider economy and corporate profitability. Yet interest rates are slowly rising, at the same time that the world carries with it more debt, both private and public, than ever before. Debt needs to be serviced, at a rising cost, at the expense of other productive uses of scarce capital. Combined with demographic pressures and tepid broad wage growth, we have what a politician would call a “less favourable combination”.

Although there may be no immediate dangers for the world economy, (trade issues and politics notwithstanding), we are very much in a late-cycle market. This means greater uncertainty and more volatility. In other words, risk is back, and with it the narrative will change. We face a more challenging environment but also one which can benefit long-term investors like Gard - a period in which we can use our advantages of an extremely strong capital position, patience and an extended time horizon to look for new opportunities at a better price.

Comments, criticisms, or restaurant suggestions are always welcome.