Navigating Equity Markets

Lessons to Remember and Mistakes to Avoid

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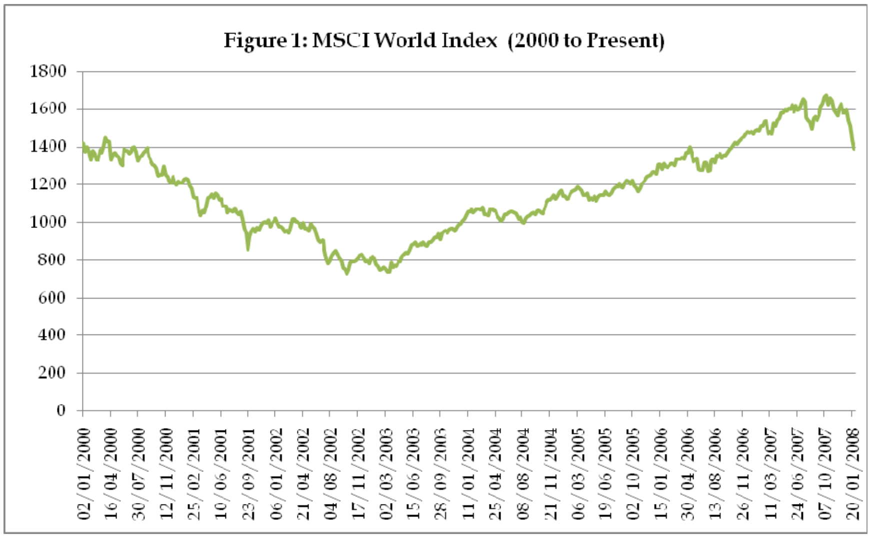
"Fear and panic give poor counsel."

Jürgen Stark, European Central Bank

1. The Economic Environment and Equity Market Backdrop

Since August of last year capital markets have been beleaguered. Amongst other things, the source of this stress includes the so-called sub-prime crisis and the associated rising aversion to risk; bad debt write-downs by financial institutions that now total some USD150bn; conflicts of interest in credit ratings agencies' practices that have resulted in tainted advice; and evidence that economic growth is flagging, especially in North America, and that price inflation remains stubbornly high on the back of sustained strength in commodity prices.

In this setting, equities have come under particular pressure. Indeed, since peaking in October 2007, the MSCI World Index has tumbled almost 15 percent (see Figure 1).



Source: Reuters, adapted by Cannon Asset Managers

However, the decline has not been uniform in its pace. Rather, as the above tensions have intensified, price declines have become increasingly severe. To illustrate this point, to date, January 2008 represents the worst start to a year for equities since records began. Further, the decline in equity prices is widespread, with all of the major markets having recorded sharp losses. By way of example, by close of trade on 22 January, Japan's Nikkei index was down 17.8 percent, Hong Kong's Hang Seng index had dumped 21.8 percent, the German DAX had lost 16.1 percent and the US equity market, as measured by the S&P500, was down 10.8% year-to-date (see Table 1).

Table 1: Movement in Leading Global Equity Market Indices Year-to-Date

Index	Move (%)
Hang Seng (Hong Kong)	-21.8
Nikkei (Japan)	-17.9
FTSE (UK)	-11.1
DAX (Germany)	-16.1
CAC (France)	-13.7
S&P 500 (US)	-10.8
MSCI World	-12.4

Source: Reuters

However, in the current down cycle, price declines have been most intense in the past week. To be sure, during the past week equity markets have recorded some of the sharpest daily losses this decade, a period that includes the tech meltdown of the early 2000s and the market crack of September 2001 which followed the 9-11 attacks on the US.

Considering some of the daily price falls in leading equity markets:

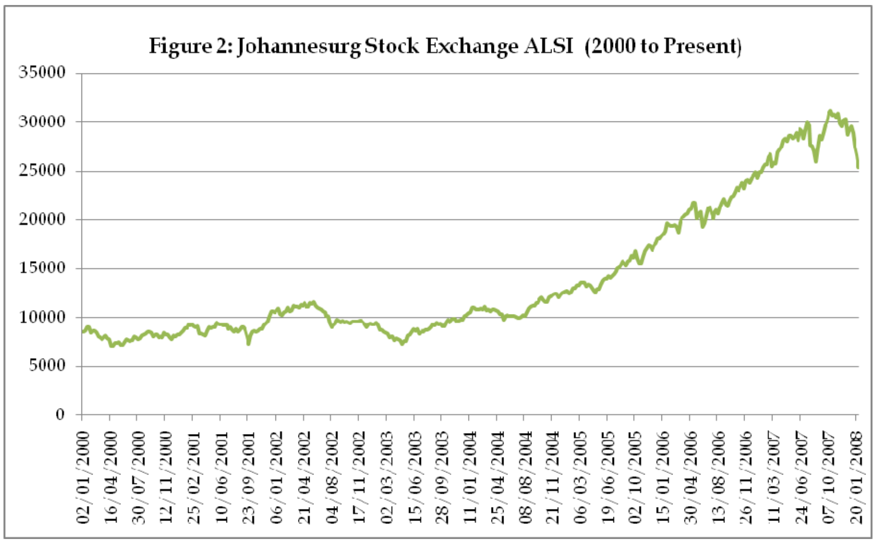
- the 5.6 percent fall in Japan's Nikkei index (22 January 2008) is the third biggest daily decline since 2000;

- the 6.8 percent fall in France's CAC index (21 January 2008) represents the second biggest daily decline since 2000, as is the case with and the 5.5 percent fall in the UK's FTSE index (21 January 2008); and

- in the case of the important Hong Kong market, the falls in the Hang Seng index of 8.6 percent (22 January 2008), 5.5 percent (21 January) and 5.4 percent (16 January) represent the second, fifth and sixth biggest daily declines since 2000.

2. The Implication for South African Equities

This harsh global backdrop has been associated with an equally unforgiving environment for South African equities. Since peaking at just over 31 500 points in October 2007, the Johannesburg Stock Exchange's All Share Index (ALSI) has shed 20 percent, reaching a local low of just over 25 000 points in the fourth week of January. Again, in line with the global trend, January has captured the bulk of this decline, with the ALSI off 12.3 percent in the first three weeks of the year (see Figure 2).



Source: Reuters, adapted by Cannon Asset Managers

3. Policy Responses and The Outlook for Equities

In turn, the tense global equity environment has been one of the factors that contributed to the Chairman of the Federal Reserve, Ben Bernanke, cutting the key lending rate in the US by 75 basis points in a surprise announcement on 22 January. Despite this relief, it appears that the Federal Open Market Committee is behind the curve, as are other leading central banks, particularly the European Central Bank, meaning that global equities, and by implication South African equities, could remain under pressure for a while longer.

In this environment of declining equity prices, coupled with high price volatility, it is worthwhile reminding ourselves of some of the most important lessons learned about equity investing, as well as some of the greatest traps that lie ready to snare investors who have become filled with fear and are acting with panic.

4. **Lessons to Remember, Mistakes to Avoid**

To this end, below is a list of the ten most important lessons for equity investors to remember and mistakes that investors should aim to avoid based on my experience as an investment manager since the mid-1990s, as well as that of others.[1]

1. Over the long term, equities are the top performing asset class. If you are an investor, then by implication you have a long-term horizon (measured in years, not quarters or months). As an investor, you should own equities.

2. Sharp declines in prices are more frequent than sharp price rises, but both are unpredictable. Avoid trying to time the market with tactical asset allocation – you are more likely to be wrong than right in your call. If you get the call right, do not confuse luck with skill.

3. Equity prices do not respond to economic activity, they anticipate economic activity. Buy equities when markets are gloomy about current economic conditions but recovery sits on the horizon.

4. Stock prices fluctuate far more widely than business fundamentals. Do not focus on short-term price volatility, but rather on the quality of the assets you own. As Warren Buffett noted: "Price is what you pay, value is what you get".

5. Stick to your investment philosophy – style drift is lethal to long-run success. However, investors should recognise that, in the long run, value stocks outperform growth stocks and do so with lower-than-market risk.

6. Markets – like horses – bolt. Never panic. If you panic, you probably are already too late.

7. Be patient. Investing is a multi-year game, yet most investors try to beat the market on a day-to-day or month-to-month basis. This so-called quarteritis leads to over-trading of portfolios. Stock brokers get rich whilst portfolio owners give away performance.

8. Forget what the crowd is doing, and remember that most professional investment managers are beaten by the market. The only way you can beat the market is by being different to the market – this means that successful strategies are necessarily based on a contrarian stance. Of course, whilst contrarian

[1] Including inspiration provided by Dr Martin Jetzer (2008) From the Desk of Our Chief Economist: What Do We Really Know about Stock Markets? *HSBC Guyerzeller*.

strategies can produce extraordinary returns they require courage, conviction and patience (factors that are scarce in the go-go world of investment management).

9. Collectively, over time, liquid large-cap stocks, or so-called blue chips, are beaten by less well known and less liquid smaller-cap stocks. Also, size and safety are not synonymous – large companies do not mean large profits; and many large companies fail – far more than investors commonly think.

10. Question everything, and know that most forecasts will be wildly wrong or wide of the mark. By the same token, recognise your own mistakes and correct errors with swift, decisive action.

5. **The Result**

By reminding ourselves of these important lessons, and successfully avoiding the mistakes that investors pathologically repeat, we can go a long way to ensuring that our investment efforts produce substantially healthier portfolio results in the fullness of time. The above list also gives us perspective to identify the current panicked equity environment as a valuable opportunity to find attractively priced, good quality assets. Fear and panic give poor counsel.

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