Process Over Panic

2022 has most certainly been a year to remember (or to forget!) in the financial markets. Reflecting on this challenging market climate versus others, one finds there are key distinctions as to how we got here. I do not want to focus on the unsettling headlines that news organizations have presented over the past three years which undoubtedly have contributed to the economic environment we are currently facing. Of course, these global circumstances affect us all perhaps in different ways, especially when considering personal finances. How investors inherently react during market drawdowns and the overriding similarities when comparing to market declines in the past is what I would like to bring to your attention in this discussion.

Relatively speaking, whether you are approaching retirement or are in the early stages of your career actively accumulating wealth, the emotional response during market drawdowns is parallel. Although the severity of these emotional responses differs based on your stage in life, the general consensus is that nobody wants to see their capital erode. **During periods of turbulence, most behavioral experts would agree that greed and fear are the two most prominent opposing emotional states that exacerbate the drastic fluctuations in the stock market.** This irrational behaviour is inconsistent with efficient markets. Let us examine some notable examples:

1. The Dotcom Tech Bubble- The Dotcom Tech Bubble came into fruition in the late 1990s and ended in the early 2000s. Multiple overvaluations in large telecom hardware providers created a supply problem which was instrumental in causing a recession in 2001. **These types of bubbles exist when there is excess capital deployed in later stages of business/credit cycles in pursuit of harvesting additional returns (otherwise known as alpha) in saturated markets. As a result, investors became "predictably irrational".** Herding and trend following is typical during periods of innovation that can unlock economic value, followed by increased leverage and overvaluation. This leads to a lack of engagement towards traditional market fundamentals. As share prices of internet companies skyrocketed much faster than other sectors due to mostly speculation, the subsequent burst of the bubble was far more pronounced than usual dips in the market. It is difficult to earmark rational behaviour during this period.

2. The Housing Bubble of 2008 - The housing bubble of easy credit and inflated home prices that lead to a recession rippled across the globe in 2008. This was a result of investors taking on loans they simply could not afford. Lenders relaxed their standards to provide credit to those who were less than qualified. The sheer volume of approvals on bad debt drove up housing prices to a level that many would otherwise be unable to afford. This storyline began in 1999 with an increase in sub prime mortgages (mortgages targeted at borrowers with less than perfect credit) to allow a larger portion of the American population to live the American dream of owning a home. As investors, pension funds, investment banks failed to see the downside, it became evident in 2007 that homeowners were defaulting at high rates. All variations of subprime mortgages were resetting to higher payments while prices declined.

Government bailouts became the source of resolve as bankruptcies stockpiled. The economy then retracted, which lead the Dow Jones to record its largest single day loss at that juncture of 774 points (6.98%). Once again, lack of discipline during the climb and panic on the way down.

3. Most recently, we can remember the abrupt and distinct sense of panic during the early days of COVID 19. The S&P500 hit its peak on February 19th, 2020. By March 23rd, 2020 the S&P500 was down over 30% from its all-time highs. The uncertainty of COVID19 had a ripple effect through the entire globe as investors sold off their holdings at a high volume. The markets did not know how to respond to this level of uncertainty. As a response, the market mechanism to combat these conditions was a record amount of fiscal and monetary stimulus. As trends in business and financial markets began to evolve in conjunction with a surge of household savings and pent-up demand, there was an enormous resurgence in economic growth. We began to see valuations in Big Tech companies that were able to adapt to the new normal surge in prices that did not reflect their underlying profits or balance sheets. In some cases, highly leveraged companies with no profits experienced price increases not seen before. Furthermore, we saw several investors riding the crypto and meme stock wave at levels that challenged the integrity of the capital markets. Since then, valuations on all fronts have retracted significantly and stock prices are more reflective of their underlying businesses.

Although these examples are spanning two decades of extreme volatility, they accurately present a good lesson for us all. **During one's investment journey, there will always be points in time that can trigger the need for an emotional response. Reacting to trends that are contradictory to how financial markets operate, or even taking extreme measures based upon hearsay can cause unplanned, poor outcomes.** A disciplined approach, diversifying across asset classes in high quality positions will always be the most prudent defense mechanism when we are faced with periods of uncertainty. Remaining steadfast to a long-term philosophy with an investment allocation that matches one's current lifestyle and risk tolerance will ensure that one stays the course in meeting long-term goals. Today, we are faced with a multitude of evolving variables that are primarily feeding into the current inflationary environment. Inevitably, this is causing investors to once again, experience that unsettled feeling. In most cases, taking no action is the best action. **Staying the course and recognizing that in time, capital markets do deliver. The tortoise will always win the race against the hare.**

Colin Marinelli, MFin, CFA
Associate Investment Counsellor
colin.marinelli@bmo.com
902-421-6212

BMO Private Wealth
1675 Grafton Street, 14th Floor
Halifax, NS, B3J 0E9