# BUILDING WEALTH THROUGH MARKET CRASHES

## THE IMPACTS OF COVID-19 ON FINANCIAL MARKETS MAY WELL LINGER. YOU CAN BE PREPARED.

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It may seem counter-intuitive to suggest that you can build wealth while stock markets are crashing, but it's true. In this article I'll walk you through a few techniques to help you avoid giving in to your worst instincts, stick to your plan, and find the nerve to be bold when everyone else is fearful. These are the things that the wealthiest investors do, and you can do them too.

2020 has felt like a decade, the longest decade I can remember. Aside from the threats that COVID-19 poses to the health of friends and family, stock markets have taken our clients on a tumultuous ride, falling over thirty percent before bottoming (for now). However, as of early August, year-to-date (in Canadian dollars) the Canadian and international markets are now down less than five percent, and the US has actually passed back into positive territory (around seven percent).

But think back to late February, when the virus had started appearing in force outside China, and markets first started lurching. On March 2nd we wrote the following on our blog, after the markets had fallen about eight percent and the crash was gaining speed:

> Until a week ago, reports of infections were spotty around the globe. Italy, Iran, and South Korea all reported increases this past week, however, with the New York Times reporting on Friday the total estimated cases in the three countries at 3,500, double the level of two days prior. As of Friday, 56 countries had reported 83,000 cases and on Saturday, the US reported its first death, in Seattle. Two thousand, eight hundred have died globally, the vast majority of which have been in China – a region that itself has reported decelerating growth in reported cases. The bigger fear of a potential pandemic has taken hold of markets, however, and driven the recent losses on the markets.

Many of those closely watching their community's portfolio balances or their own retirement investment account felt a pang of panic at this point. Their gut told them "Get out!" What did yours say? Did the sense of risk that swirled around you make you want to sell all your stock and hold cash?

Here is what we did for our clients as markets tumbled from this point, on through the trough and thereafter: step in and buy stock. Why was this a good idea? And how did we get to this decision? We followed the following set of principles.

**Markets are driven primarily by two things: companies' profit expectations and investors' emotions (reflected in willingness to pay high or low prices for those profits or earnings). Understand what's currently driving the bus.** As value investors, we believe that good companies don't necessarily make good investments. Good investment returns are more often derived by owning quality companies run by aligned management teams, generating solid future earnings and paying a low price for those earnings.

In the first few weeks of market declines due to the COVID-19 crisis, all stocks fell, even ones that would have little impact from it. Gold stocks – which tend to rise in times of crisis, as investors seek to hold the gold commodity as a source of stability – also fell.

When this was happening, we recognized that while earnings outlooks had certainly darkened, investor emotions were dominant. Fear was driving investors to extreme levels of pessimism and motivating them to dump stocks at bargain basement prices. Even relative to the most pessimistic earnings outlooks, the prices (as multiples of future earnings) of good companies started to look cheap. This is important because, if history is any guide, over time these multiples will normalize back up. Investors therefore only needed to find companies that would a) survive the short-term cash shock of the closed economy and b) post modest earnings growth thereafter to have a reasonable chance of delivering good investment returns.

**Understand that risk is relative.** At any point in time, the level of "risk" of an investment reflects the chances in the future that it goes up versus the chances that it goes down. In other words, its range of possible future

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returns. When your stock holdings are down thirty percent, it's human nature to get stuck looking at those losses (on paper) and gloomily conclude that they will continue to accelerate down. But the fact is that when a stock declines in price, its future upside return potential (all else being equal) statistically goes up.

Consider a company with a price of $100 that you hold because you think it will rise to its "true" value of $120. COVID arrives. The stock falls to $70. At that point in time, even with the murky outlook of COVID, the upside scenario is much better than the downside one. It may take time, but it's expected you're more likely to see it rise back to $100 (for a +42% return) or even your original goal of $120 (+71% return) than to see the inverse: falling another -42% or -71% to $41 or $20, respectively.

Put another way, when good stocks have already taken a beating, you are actually at a much lower level of risk in holding or even adding to them. In this way, at the time you are feeling the most vulnerable is in fact the time that stocks offer you the most opportunity.

All of this is dependent on the business being able to survive, which is of course not guaranteed. The purest version of this example assumes that the market has irrationally punished the stock when the underlying business expects little disruption to its operations. The other extreme is that it goes bankrupt. Hiring a money manager who can determine where each business falls on that spectrum is your best first decision. Following their advice to remain invested through the period is the next.

**Time is your friend.** One of the best ways to find the courage to buy "risk" assets such as stocks is to remember that if you are investing for your own distant retirement, or looking after a trust that is intended to fund community projects for decades to come, you can afford to be early or a little late, because over the long-term, the earnings of the companies in your portfolios will normalize, and the market is trading like they will not. You just need to have the nerve to hang in there, or even commit additional money to stocks if you can afford it.

**Be aware of your own biases.** One hard lesson to learn (and remember) is that your brain is not always on your side. A number of biases that can lead us to make bad decisions, especially when under pressure, are hard-wired into us.

> *Representation bias* is one. This is where investors confuse two related but in fact unlinked concepts such as "A good company selling at a lower price is good value, so low-priced stocks are all good value." Businesses are not all created equal, nor did they equally absorb the shock of COVID-19. Assuming so could have led investors to make some big mistakes.
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> Another is *confirmation bias*, which is interpreting data as reinforcing your pre-existing views. Humility is one of the most important traits when investing in times of great uncertainty. Locking in your conclusions about the speed of infection declines or the timeline for economic recovery – and then ignoring data that dispute those views – can be very costly.

A related concept is the need to maintain flexibility in your thinking. High-quality companies that may have been unbuyable for years, due to their high price, need to be considered with fresh eyes. And companies you've loved (or even held) for a long time must be subject to close scrutiny if the disruption to their business threatens their very survival.

**Be willing to make mistakes.** This is a principle that's hard to apply even in stable markets, but the best investors allow themselves the leeway to be wrong. As long as you (or your portfolio managers) are doing the analytical work, it's okay (and usually necessary) to invest in some companies with higher levels of uncertainty attached to their outcomes. As discussed above, the upsides are generally better than downsides in the midst of a crisis. Finding the nerve to act boldly at that time, when the analysis recommends it, is crucial.

**Be willing to learn from mistakes.** An important pre-requisite to taking investment decisions is committing yourself in advance to intellectual honesty with respect to those decisions. This means keeping good records of decisions you make and the reasons behind them, so that when things work out as planned (or don't), you can reflect and learn.

**Allow your Investment Policy Statement (IPS) to do its job.** Investment advisors develop IPSs with their clients to help build a suitable portfolio that will enable the long-term achievement of their investment objectives. Generally speaking, it is designed to be valid as long as the investor's own financial situation (job, bills, assets), investment goals (required amounts, timeline), and appetite for risk remain unchanged. Assuming you don't encounter fraud, *the asset mix in your IPS (percent stocks, percent bonds) is in fact the biggest determinant of achieving your long-term investment goals.*

As a planning tool, the IPS anticipates periods of market declines, so it's important to stick to the process when it's tempting to reduce your risk (stocks) in the midst of a crisis. Selling low in a panic, only to buy back in high when markets have recovered, can seriously impair performance and possibly threaten your long-term goals. In fact, when stocks fall as a percentage of the overall portfolio, it's important to rebalance (sell bonds, buy stocks) to maintain that strategic mix and take advantage of low stock prices in the process.

When everything that seems capable of going wrong appears to have gone wrong, those with the most clarity feel hope, not despair. Honing the ability in the midst of a crisis to find that hope and courage and resolve will help you navigate the coming months and years – for the impacts of COVID-19 on financial markets may well linger and flare for some time to come. The nature of future market crises will undoubtedly change, but these principles that govern our process will apply. And now you, too, can be prepared.