CAPITAL
FINANCIAL SERVICES
Making the most of your assets

Pandemics and Bear Markets

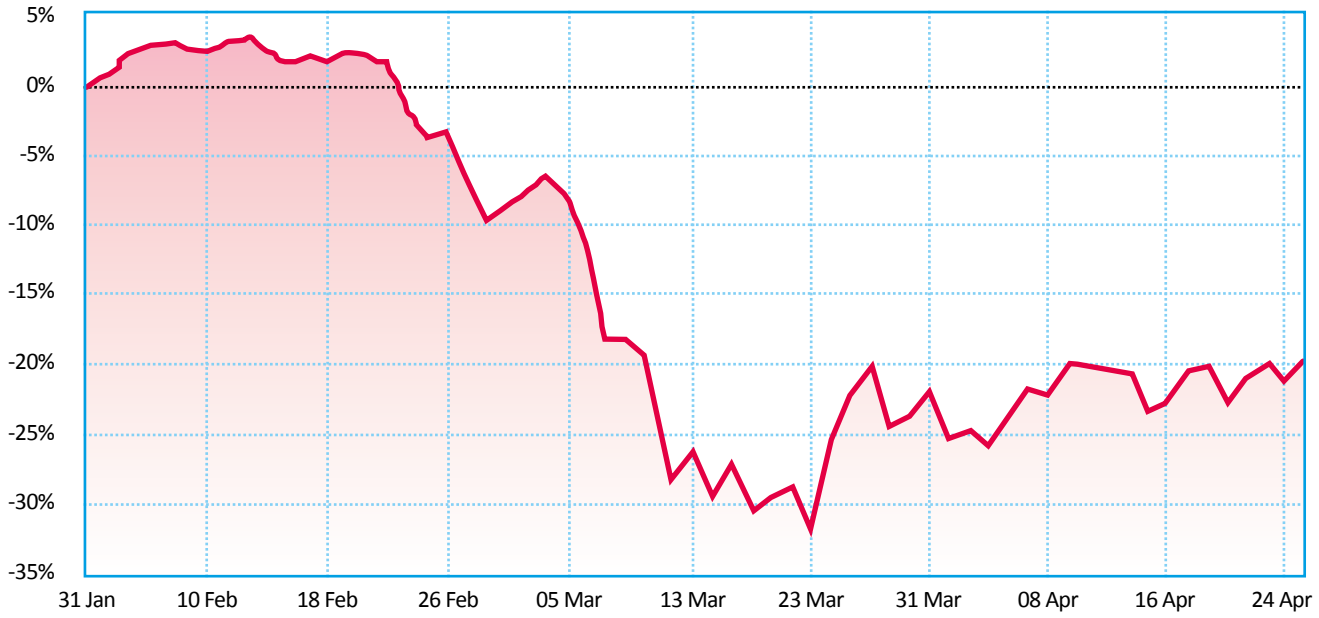
Making sense of investing during difficult times

There is no doubt that we are currently living in uncertain and unprecedented times. This has naturally created feelings of anxiety for many people. It might seem like there is much to worry about at the moment, but how concerned should investors be about the value of their holdings? The news reports frequently mention the global economic impact and turbulent days on the stock markets but this does not necessarily translate into doom and gloom for investors.

It is very easy when stock markets are falling to become fearful and then attempt to take corrective action by changing investment strategy. All too often though, such hasty decisions, driven by nervousness, will turn out to be poor decisions that are costly in the longer term.

Within this update, we look at the current impact of the COVID-19 crisis on the stock market and look closely at how markets have behaved in other periods of downturn. Most investors that seek professional advice will have a diversified investment portfolio that has been carefully constructed to protect them from the full extent of a large drop in market values. The benefits of diversification in the current environment are also explored.

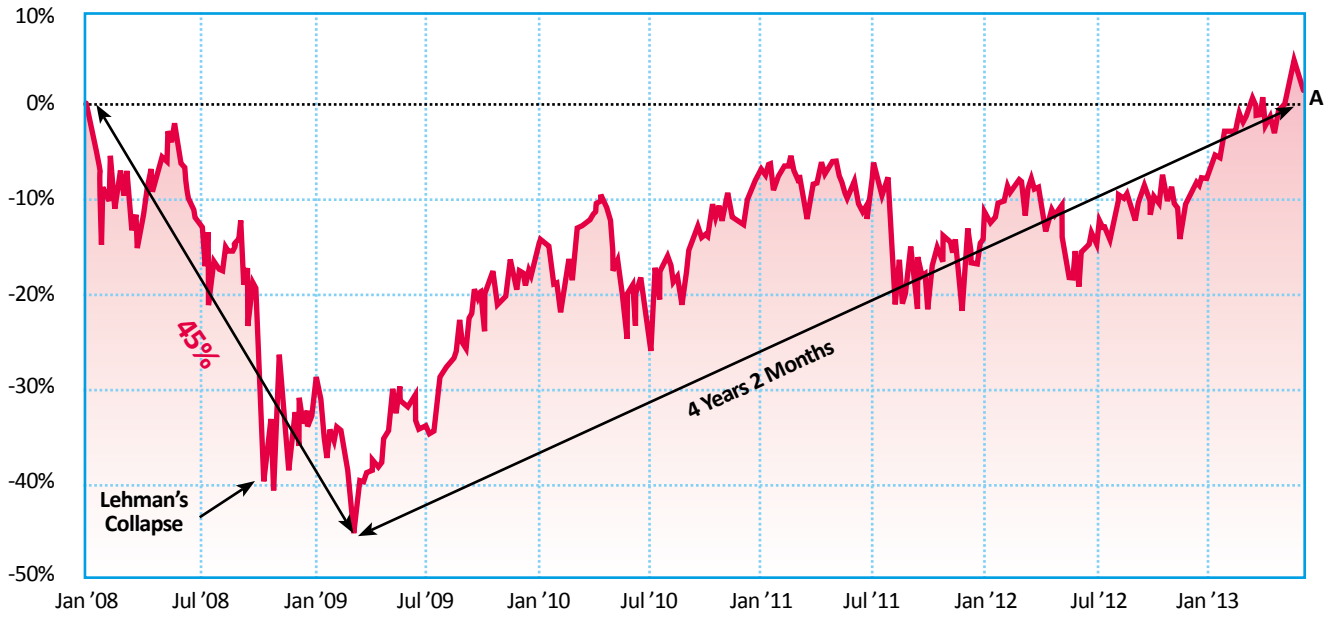
The chart below shows the FTSE-100 Index from 1st February 2020 to 27th April 2020.



Source: FE Analytics 28/04/2020

The downward trend starts mid-February (there is a fall of 1.6% on Valentine's Day). The current low point, an index value of 4993, was reached on 23rd March. This represents a total fall from the mid-February levels of around 33.72%. Further falls are certainly possible and much will depend on the ability of governments to ease lockdowns without a second wave of COVID-19 infections emerging, and the true extent of the economic damage that will eventually become apparent. However, for now this 33.72% figure represents a known impact of COVID-19 on the FTSE-100. Incidentally, whilst the market is naturally quite volatile and has generally been moving sideways for the past couple of weeks, growth in the FTSE since 23rd March has been in the region of 17%. As is apparent on the chart, any decisions made in mid-March to have sold out of investments in response to continued market falls would have thus so far proved to have been poor decisions. Investors would have missed out on the potential of up to 17% growth.

So, how does 33% compare to other market downturns in history? Let's look back to the 2008 global financial crisis. The chart below shows the FTSE-100 Index from 1st January 2008 to 31st May 2013.



Source: FE Analytics 28/04/2020

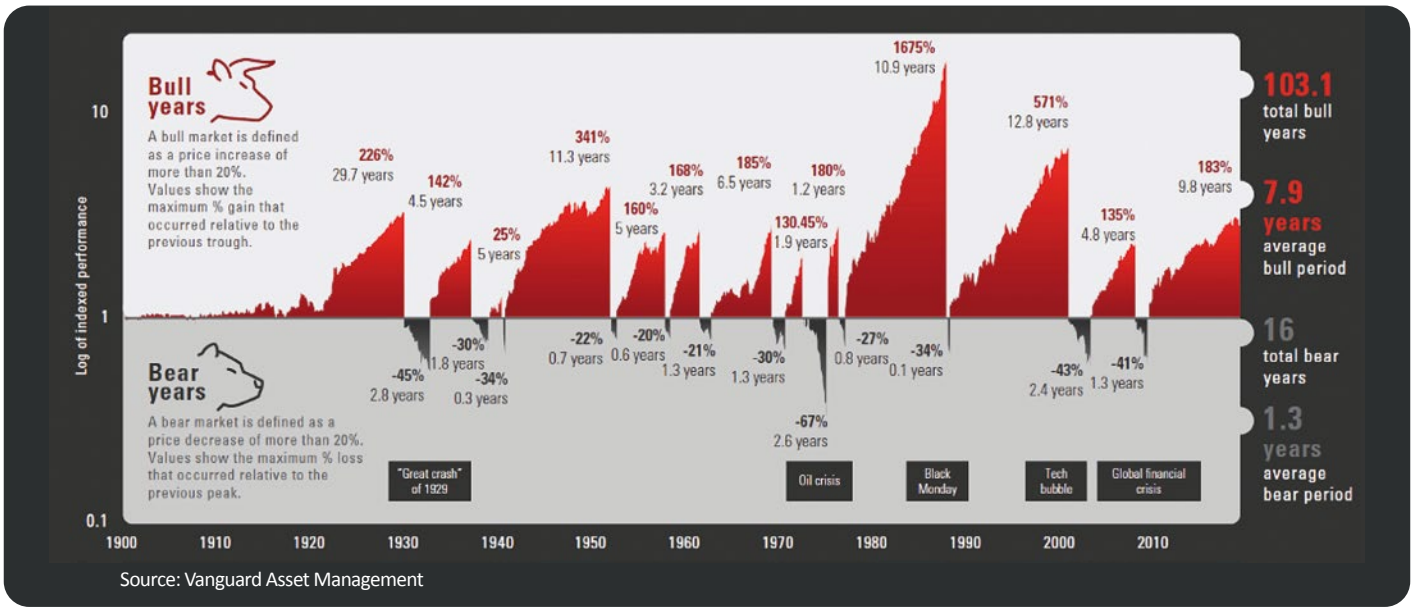
The market fell throughout 2008 and into 2009, with the FTSE-100 reaching a low in early March 2009 of 3531. One of the most dramatic daily falls came in November 2008 as Lehman Brothers Bank collapsed. It then took four years and two months for the market to recover to pre-2008 levels, a relatively short-period of time, considering the scope of the global financial crisis and the magnitude of the market drop. Furthermore, as can be seen on the chart, a significant proportion of this recovery happened by January 2010, less than one year from the market low point.

This really illustrates the importance of remaining invested at the time of market crisis and sticking to the original investment strategy. Anyone panic selling at the news of the Lehman's collapse in 2008 would have crystallised losses and missed out on significant market recovery only a few months later.

It is worth noting that back in 2008, banks were in a weak financial position and many had virtually run out of money. Thanks to new regulation and more stringent capital requirements introduced in response to the global financial crisis, banks today are better capitalised and in a much stronger position. This could be crucial when it comes to dealing with the economic impact of the COVID-19 crisis, as the willingness of banks to lend could be key to kick-starting the global economy.

So, how long could this current period of market instability last? Well, nobody can tell for sure and as already mentioned, much will be dependent on the ability of global governments to ease restrictions without a second wave of infections and ultimately a successful COVID-19 vaccine may be required. The downturn in the 2008 financial crisis lasted about one year and four months before the upturn started.

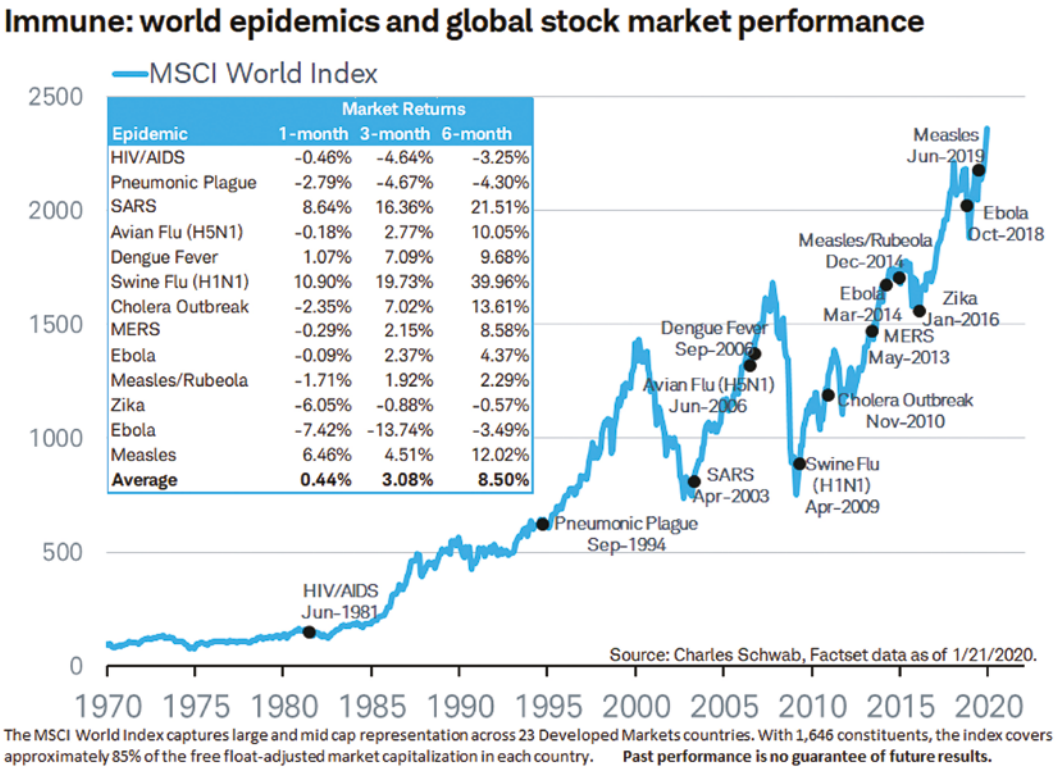
Research undertaken by Vanguard Asset Management has looked at bull and bear markets since 1900. A bear market being defined as a price decrease of more than 20%. The research was based on the FTSE All-Share Index and shows 12 bear periods prior to the current COVID-19 crisis. The average length of the drop from high to low across these periods was 1.3 years, the same as in the 2008 financial crisis. The downturn resulting from the great crash of 1929 was one of the most prolonged downturns, lasting 2.8 years.



Source: Vanguard Asset Management

This chart clearly demonstrates that bull market runs are much more prevalent than bear markets, lasting an average of 7.9 years. There is clearly significant investment growth to be made during the bull market years and it's impossible for anybody to accurately predict when the next bull market will begin. Therefore, sticking with the original investment strategy is key.

It is also worth considering that COVID-19 is not the first time that stock markets have reacted to a pandemic. That said, the severity of COVID-19 in terms of both the infection rate and the economic impact of the lockdowns to control the spread will undoubtedly be greater this time. The chart below from Charles Schwab shows global stock market performance, measured using the MSCI World Index. Market returns over one month, three months and six months, immediately following other notable outbreaks are highlighted.

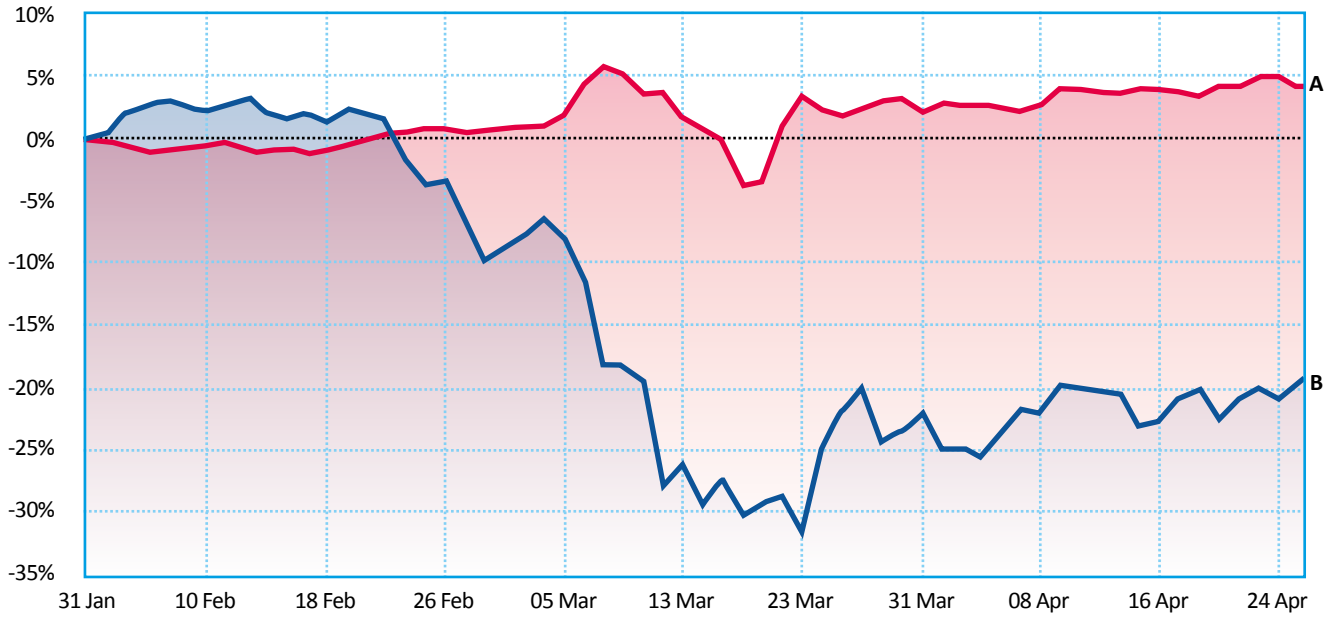


Epidemic	Market Returns 1-month	3-month	6-month
HIV/AIDS	-0.46%	-4.64%	-3.25%
Pneumonic Plague	-2.79%	-4.67%	-4.30%
SARS	8.64%	16.36%	21.51%
Avian Flu (H5N1)	-0.18%	2.77%	10.05%
Dengue Fever	1.07%	7.09%	9.68%
Swine Flu (H1N1)	10.90%	19.73%	39.96%
Cholera Outbreak	-2.35%	7.02%	13.61%
MERS	-0.29%	2.15%	8.58%
Ebola	-0.09%	2.37%	4.37%
Measles/Rubeola	-1.71%	1.92%	2.29%
Zika	-6.05%	-0.88%	-0.57%
Ebola	-7.42%	-13.74%	-3.49%
Measles	6.46%	4.51%	12.02%
Average	**0.44%**	**3.08%**	**8.50%**

By comparison, since COVID-19, the MSCI World Index fell by 10.86% for the one month period of March 2020. This has been followed by strong growth, with the index up by 13.68% for the period 1st April 2020 to 27th April 2020.

Of course, not all investment markets necessarily behave in the same way at the same time. While one type of asset is falling in value others may still be going up in value. The charts above focus on equities. However, there are other asset types to consider holding in a portfolio. These assets can include government bonds (gilts), corporate bonds and property. History has shown us that equities tend to outperform other assets over the longer term. For this reason, it is usually a good idea to include equities within a long-term investment portfolio. Holding other asset types alongside equities adds diversification and this helps to reduce volatility, limit the impact of sharp downturns in equities and smooths out the overall returns. Most investment experts will recommend holding a mix of several different asset types within a portfolio to provide diversification.

Look again at the chart showing the FTSE-100 Index since the 1st February 2020. This time we have also included the returns on UK government bonds (gilts) over the same period.



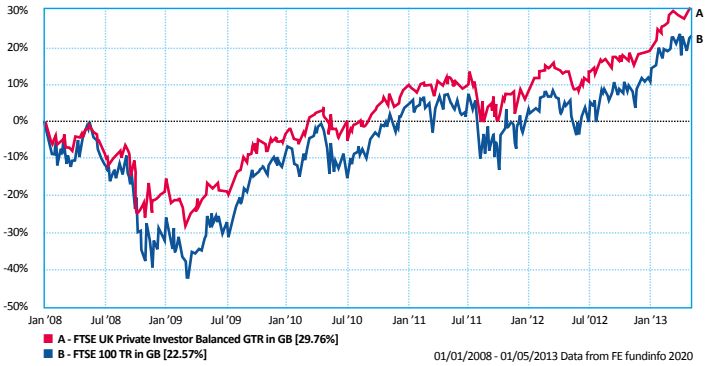
Source: FE Analytics 28/04/2020

It can be seen that although there was still a downturn in gilts in mid-March it was a much smaller drop than the fall in equities (around 9% from the highest point to the lowest point) and that this has quickly recovered. Gilts have actually increased in value overall during this period. Most investors would not necessarily want to hold only gilts, as long term returns can be much lower than the returns on equities. However, a portfolio that contained gilts as well as equities would have been at least partially shielded from the full extent of that 33% drop in the FTSE-100 during March.

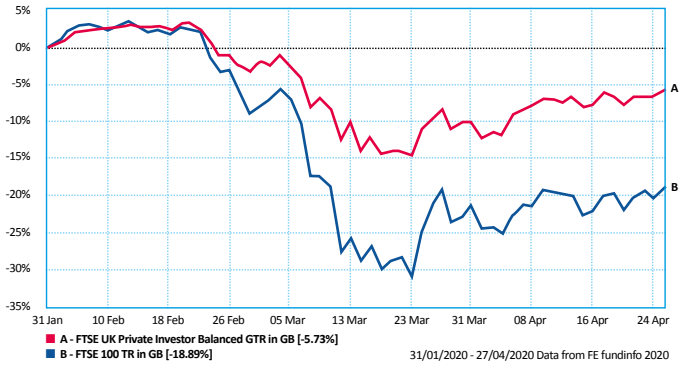
Deciding on the correct mix of different asset types within your portfolio requires careful consideration of your objectives and an examination of the amount of investment risk you are willing to take. Increasing the amount of equities within a portfolio increases the risk, while decreasing the equity holdings in favour of other assets may reduce the risk. Your financial adviser will take all of this this into account when making a portfolio recommendation. Financial advisers understand the importance of recommending well diversified portfolios. For this reason, the true impact of the current market downturn on the investment portfolios held by their clients will often not be anywhere near as dramatic as the stock market values reported in the press might suggest.

Let's examine how a typical diversified medium risk portfolio has behaved in comparison to the market, during both the 2008 crisis and the current downturn.

The blue line on the charts below shows the FTSE-100. The red line shows a benchmark index for a balanced portfolio containing approximately 60% equities, split between UK and international equities, with the remainder of the portfolio being made up of cash, property, bonds and alternative assets. Income from interest and dividends is reinvested.



2008 Global Financial Crisis



Current market downturn

Source: FE Analytics 28/04/2020

It can be seen that the balanced portfolio fell far less than the FTSE-100 during the global financial crisis and recovered to pre-crisis levels by early 2010. It then continued to outperform the market. In the current market downturn, the same balanced portfolio has fallen in value by only about half of the amount of the FTSE-100.

In conclusion, the stock market downturn caused by COVID-19 has been significant, but also to date smaller than the downturn in some other recent bear markets. Bear markets tend to be relatively brief compared to bull markets and full recovery does happen eventually. Often large gains are made during the early part of the recovery phase. During the 2008 global financial crisis we experienced greater falls in investment values than have been experienced to date during the COVID-19 crisis. Market recovery following the financial crisis took only a little over 4 years, with a significant proportion of gains being made during the first year of recovery.

A diversified portfolio helps reduce volatility and can protect against the full extent of market falls. Taking this multi-asset approach often means that a portfolio will fall in value by much less than the market and recover much more quickly too! A diversified and professionally managed portfolio is unlikely to have been impacted to the same extent that the news headlines may suggest. Your financial adviser will be able to talk to you about the diversification within your portfolio and whether it is appropriate for the amount of investment risk that you have indicated that you are willing to take. Your adviser will also be able to help you to understand whether your investments remain on track to meet your long-term investment objectives.

Long-term investors are best advised not to change investment strategy in response to any market crisis. There is a definite risk of selling at the wrong time, turning losses on paper into real losses or missing out on the start of a recovery phase when significant gains are usually made. For the same reasons, it is rarely advisable to delay making decisions on new investments. Unless the economic uncertainty has created doubts over the affordability of a planned investment, it is usually advisable to go ahead with the investment now and avoid missing out on that recovery phase when it begins. If you were considering making a new investment, but are unsure what to do then seek guidance from your financial adviser. The longer you wait, the greater the risk that you will have left it too late.

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