OUTSIDE THE FLAGS

2020: Building Resilience

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In media forecasts for 2020, a global pandemic and the worst recession since the 1930s weren't high on everyone's list of threats. But even had these events been foreseen, who would have tipped global equities to reach record highs a year later?

Yes, it's a cliché to compare the ups and downs of the share market to a rollercoaster, but for once the metaphor has rung true. After many markets hit record highs in February, they suffered a gut-wrenching slide of more than 30% in five weeks.

The recovery from April was just as dramatic. By late November, the MSCI World index had surpassed February's pre-pandemic records. Investors began to anticipate an economic recovery and were cheered by news that three different vaccines, promoted by their makers as highly effective, would soon be available.

The sheer volatility in prices mirrored our emotional swings. After all, this was a health crisis first and foremost. As of early December, 1.5 million people had died from COVID-19, while more than 62 million cases had been reported worldwide.[1]

On top of the medical anxieties were threats to livelihoods. With entire industries and economies severely disrupted by the pandemic, governments and central banks announced unprecedented levels of policy stimulus. Even so, the International Monetary Fund in October projected a historic global GDP contraction of 4.4% in 2020, the worst annual plunge in activity since the Great Depression.[2]

COVID-19 also changed the way we lived and worked. Our homes became offices and classrooms. Time formerly spent commuting was now absorbed with work and study. For some, the working day started much earlier. For others, it ended later. Old schedules were discarded.

Perhaps what was most striking is how well we adapted in the face of significant economic and social disruption. Previously unthought of travel restrictions, social distancing, mask wearing, and contact tracing apps are now facts of life.

The urge to protect ourselves and our loved ones from an external health hazard was such we were prepared to give up some freedoms. Granted, not everyone accepted these without complaint, but compliance was the rule rather than the exception.

The rules around good investment practice were reinforced as well. When volatility turned so extreme in late March that even the US Treasury market became unsettled[3] ,there was a temptation among many to retreat to cash. But those who listened to their advisors would no doubt be thanking them now.

The first rule we were reminded of is that markets work. That doesn't mean they're perfect or that they go only in one direction. When there is a lot of uncertainty, there will be a lot of volatility. But trying to second-guess prices is futile. Even if you could forecast news events like a pandemic, you still have to work out how markets will react.

Given the impossibility of outguessing markets, the second rule is to rebalance to maintain one's chosen asset allocation. Amid the sharp decline in shares in the first quarter this year, bonds – like shock absorbers in a motor vehicle - continued to play a key role in preserving capital, lessening portfolio volatility and making for a less bumpy ride. Those who used this opportunity to rebalance their portfolios back toward their desired allocation reaped the benefits.

Third, diversification was again shown to be critical in improving the reliability of outcomes. Obviously some stocks and sectors were more exposed to a pandemic that brought travel to a virtual halt and reduced human contact. Airlines, cruise ships and tourism-related stocks were all hard hit, as were traditional bricks-and-mortar retailers.

On the other side, home entertainment stocks like Netflix, digital media companies like Facebook and Google, online retailers, and some healthcare stocks did remarkably well. In Australia, gold and iron ore miners bucked the overall downtrend. Being broadly diversified matters because it reduces risks associated with individual companies or sectors and is a critical tool in reliably capturing the premiums you are targeting.

Fourth, rarely has the value of discipline been demonstrated so vividly. While there was no denying the anxiety we felt, trying to get off the rollercoaster in the middle of the ride was only likely to make matters worse. Well-advised investors instead learnt to hold on tight and stay focused on their destinations.

Of course, there inevitably will be further challenges ahead. Markets may become volatile again, as is their nature. The pandemic is still with us. While there has been encouraging news on vaccines, hurdles have still to be overcome in manufacture, storage, distribution and compliance. While many economies, including Australia and New Zealand, have bounced back from the initial shock, scars remain.

But the philosophy underlying effective personal responses to external health and wealth threats is similar. In both cases, we do best by focusing on what we *can* control. In health, this includes frequent hand-washing, mask-wearing and social distancing. In wealth, it is asset allocation and rebalancing, diversification, discipline, and accepting that markets will do what they do, absorbing news instantaneously and looking forward.

None of this can ever make the uncertainty go away. But it can make us feel less anxious and more resilient in the face of whatever comes our way in the future.

That's the best lesson 2020 gave us.

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1. World Health Organisation COVID-19 Dashboard.
2. World Economic Outlook, *IMF*, Oct 2020.
3. Monetary Policy Report, *US Federal Reserve*, June 2020.