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CIO Viewpoint 2H2019: *Risk Matters*

It is hard to ignore the risks that are building up in global capital markets. Returns from equities and bonds have been quite attractive over the last few years, supported by falling rates, strong US-led economic performance, technology-driven innovation and accommodative policy makers. While interest rates continue to head south and many aspects of the US economy remain strong, there are rising risks threaten the ageing bull market. Some red flags that we observe are:

- OECD's economic lead indicators are pointing to a slowdown in momentum in key economies around the world, including the US and Europe. Emerging economies like China and India are facing their own challenges, whilst others like Turkey and Argentina are already in crisis mode.
- Geo-political risks are elevated. Trade war seems to be taking its toll on both US and Chinese economies, the two largest in the world. If the two leaders manage to resolve their issues or roll back tariffs, it could reverse a lot of the damage and take equity markets higher, but the probability of such an event appears to be diminishing. There are other issues that can get out of hand - Iran, Brexit, protests in HK and Korea-Japan stand-off - with varying implications.
- Key market indicators**,** particularly the yield curve inversion, are pointing to the risk of recession in the US. Technical indicators in US equity markets, particularly divergence in momentum indicators and weakness in broader indices, suggest that markets may be rolling over.
- Unprecedented behaviour of bond markets raises many systemic risk issues. Around 25% of global bond market, including Government and corporate debt, now offer negative yields. Just 3% of global bonds offer yields of over 5%, as a recent FT article pointed out. Some banks have now started offering negative mortgages. All these flies in the face of established economic theories and consequences are difficult to fully comprehend. Low and negative yields make it extremely challenging for financial institutions and pension funds to generate returns required to stay profitable and meet their obligations, let alone creating buffer for any future downturn. Investors are being increasingly forced into higher risk assets to generate even modest returns. When market sentiment changes and investors head for the exit, the gates may appear quite narrow.

All of the above does not mean that bear markets have started, as timing bear markets can be notoriously difficult. Things can reverse quickly as well. For instance, if Trump steps back on tariff war with China, markets could rally again and some of the economic damage can be reversed. If the Fed decides to be more aggressive in cutting rates, markets are likely to respond positively. Even in the past, equity markets have moved up for a year or two after initial yield curve inversion. Since equity dividend yields are higher than yield on ten-year treasuries, equities do look well set to deliver excess returns in the long run over bonds and may continue to attract capital.

Nevertheless, it is important to familiarise ourselves with bear markets at this stage when risks are still manageable amid the signs pointing to such a possibility.

We present below a short summary of bear markets in the US over the last 100 years. There is no textbook definition of a 'bear market' per se, but a 20% fall has been used as the popular threshold and so we will use that definition as well in our analysis. We also used monthly price data, rather than daily data, to avoid 'noise' and false alarms. We classify markets into three broad phases:

- **Bear market**: Over 20% fall in index, based on monthly data.
- **Bull recovery phase**: The phase from market bottom to the starting point of the bear market. This is the time taken for investors to recover capital values to pre-bear levels. We ignore smaller bull/bear phases within this recovery phase (for instance, during the long bull recovery phase of 22 years from 1929, there were several smaller cycles including a 300% move up from 1932 to 1937 followed by a 53% fall from 1937 to 1938).
- **Bull take-off phase**: The phase in the bull market beyond the starting point of the bear market.

Major Cycles	Start Month	% Change in Index	Bear Mkt (Yrs)	Bear Mkt CAGR	Bull Recovery Phase (Yrs)	Bull TakeOff Phase (Yrs)	Total Bull Market (Yrs)	Bull Mkt (Comp. Annual Growth)	% of Prior Bull Gains Lost
Bear 1	Aug-29	-86%	2.8	-50%	22.2	7.3	29.5	10%	
Bear 2	Dec-61	-23%	0.5	-42%	1.1	5.3	6.4	11%	25%
Bear 3	Nov-68	-33%	1.6	-22%	1.8	0.7	2.5	21%	66%
Bear 4	Dec-72	-46%	1.8	-30%	5.8	0.4	6.2	14%	120%
Bear 5	Nov-80	-24%	1.7	-15%	0.3	4.8	5.1	25%	43%
Bear 6	Aug-87	-30%	0.2	-76%	1.6	11.2	12.8	16%	45%
Bear 7	Aug-00	-46%	2.1	-26%	4.6	0.5	5.1	13%	55%
Bear 8	Oct-07	-53%	1.3	-43%	4.0	6.4	10.4	14%	111%
Average		**-43%**	**1.5**	**-38%**	**5.2**	**4.6**	**9.7**	**16%**	**66%**

Source: Bloomberg, Lighthouse Canton

Key observations:

- On an average, bear market fall tends to be around 43% on an absolute basis or 66% of prior bull market gains (i.e. if the current market correction turns into a bear market, this implies a potential 43-50% fall from the recent high)
- Bear markets can be vicious, falling at 2.4x the pace of a bull market, and cause the entire damage within a short span of just 1.5years (i.e. take us back to end 2012 levels)
- It could take investors an average of 6.7years to see their capital values return to pre-bear market levels
- Bull market compounds at 16% p.a., while across the cycle long term returns have been around 9% per annum. Protecting capital during bear markets can lead to substantial outperformance or excess returns

Investment Take-Aways

Even if you are not an equity investor or are a bull on global equities and do not expect a bear market in the near term, it is worth taking note of the data above as it showcases how debilitating bear markets can be to long-only portfolios. As we have seen in recent bear markets, correlations start going towards one i.e. most assets tend to fall together, and it is difficult to find a place to hide in full blown bear markets. The best time to plan for a bear market is when you are not in the midst of one.

What should investors do to earn decent returns while protecting capital in such an environment? We suggest the following, which are reflected in our core model portfolios:

- Focus on capital protection, rather than increasing risks to increase return/yield
- Diversify into assets & strategies that have negative/low correlation to markets
- Reduce directionality and beta in your portfolios
- Reduce/eliminate leverage and build up cash/capital buffer
- Buy protection, either through outright hedges or through opportunistic trades
- Stay liquid and reduce exposure to illiquid assets

At the beginning of this year we had mentioned that it is important to increase allocation to managers and strategies which are likely to earn decent returns if bull markets continue, but also have a clearly articulated strategy to protect capital and find opportunities in a bear market. Our views have not changed. Recent events have only reinforced the importance of that even more. In our list of recommended external strategies, we have added a few more non-directional high alpha fund managers both in equities and credit. Our internal strategies, LC Beacon Global Fund and LCV Trade Finance Fund continue to deliver returns without relying on market direction, reinforcing the uncorrelated nature of their strategies. Despite the rather cautious view of the equity markets, we believe that alpha generation is still possible through diligent selection of managers in this strategy space. With that in mind, we continue to have select equity strategies in our portfolios for core equities allocation,

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as we believe that these managers can deliver high returns across the cycle and are better positioned than their respective peer group to navigate turbulent times through their disciplined approach to investment both in terms of process and risk management. For instance, the primarily macro and sentiment driven sell-off in small and mid-cap stocks in India over the last one year is offering some compelling investment opportunities for Sage One India Growth Fund. Despite the market volatility, the Fund is holding a portfolio of companies with strong earnings growth and high profitability generated through their efficient business models and as importantly strong corporate governance. As for the LCM Global Growth Fund, we believe that the diversification of the portfolio has placed the Fund in a reasonably good position to mitigate risk of large downside risks in bear markets by using a combination of disciplined stop losses, alpha shorts and put options. Each of our recommended managers in equities have demonstrated their ability to deliver superior risk-adjusted returns over the different market cycles. Outside of traditional asset classes, we have highlighted gold as an interesting asset class, as gold tends to outperform equities by 4-6x during equity bear markets. With banks and bonds charging customers to park money with them, gold is likely to attract more demand as a safe haven.

We believe that a well thought out portfolio should continue to generate attractive returns across different market cycles, without causing undue stress to investors. We strive to achieve this for our clients every day and watch markets closely, so that you don't have to. We thank you for your continued support and confidence in us.

Yours Sincerely,

Rajesh Sundaresan

CIO of Lighthouse Canton