

June 8, 2008

The Problem

The most oft asked question by investors to me these days is “When is it going to recover?” I get the feeling that deep down inside everyone is thinking that as soon as the index touches 21,000 we will redeem all holdings from equities and mutual funds and sit in cash. I do not blame this thought process, as equity portfolios have eroded for many by as much as 30% and no one likes that. However, I’m trying to figure out the cause of this feeling as equities have always been volatile and thus negative returns which sometimes last for a long period of time are not new. Events in the last 5 months has simply brought to fore once again this fundamental risk in equities. This risk was somehow hidden in the last 4 years leading many people to forget this risk and believe that it does not exist. Every expert was talking about the great Indian growth story and how India has arrived on the world scene. For the first time in the last 17 years, India’s growth was coming close to the growth rates of China. In the last 5 months none of those fundamentals have changed radically but the markets have. Despite a heap of concerns I have not heard any expert predicting India’s GDP growth at less than 7% for the financial year 2008-09 but I have heard no one who tells me that the market will form new highs in 2008.

Time and again in the last four years every time the market dipped they bounced back very soon with a vengeance. This led many people to believe that it’s an easy game, invest at market falls and make hefty gains as soon as it bounces back but somehow in 2008 it did not happen. A mild recovery in the month of April until mid May is also fading away. Further, from the news that you read or hear everyday, there seems to be no respite in sight. The following international and domestic factors are hogging the limelight these days:

- Crude Oil has hit USD 139 per barrel
- Inflation is at a 44 month high of 8.24% and likely to head higher
- Interest rates are climbing up again after a brief round of minor cuts and pause
- Input costs for various corporate continue to climb higher due to increasing commodity prices and its effects on intermediates

Investors who are most affected by the recent fall are the ones who thought that markets will go up again just like they have done in the last 4 years and overexposed themselves i.e., invested more than what they possibly could absorb. The perception about risk had changed and markets were perceived safe as they were *generally* going up.

The Situation

Fact 1: Predicting is guesswork

I do not know where the market is headed in the next 3 months or even by the end of the year. Infact in one of my recent meetings a prospective investor confronted me and questioned as to how do you expect to get business if you do not have a view. My simple admission was *I do not need to know* where the market is headed to prepare a plan.

Fact 2: Markets will always give you an opportunity to regret

Today investors have the following regrets:

1. Why didn't I pull out at 21,000? OR
2. Why did I invest at 21,000?

Sometimes earlier the regret had been:

1. Why didn't I invest on 17May2004? OR
2. Why didn't I invest MORE earlier
3. Why did I pull out at 6,000? 12,000?

Sometimes in the last 4 years the regret was

1. Missing the opportunity to invest when the market had fallen
2. Missing the opportunity to book profit at a high and then re-enter at a lower level

Fact 3: Equities as an asset class have delivered the maximum returns across countries and territories, and there is no reason why this should change

Today we are concerned about all of the above and maybe more things will happen just like in the past we have been worried about

- India on the brink of bankruptcy in 1990
- Rajiv Gandhi Assasination
- South East Asian Currency Crisis
- Iraq War
- 9/11

The Solution – What to do?

Re-check your financial plan – Have things changed? You could start with asking the following questions to yourself?

- Do you have sufficient Emergency Fund?
- Do you have sufficient Insurance Cover – Life/Health/Property/Motor?
- Have your earnings come down?
- Have your expenses gone up?
- Is any major expense expected to hit you in the next 1/2/3 years for which you would need to dip into your equity portfolio?

Answers to the above could lead to a change in your current portfolio.

Also if you are holding back investments in equity that you had planned i.e., you are getting risk averse then ask these questions

- Has your risk profile changed?
- Are you holding back because external situations don't look too bright?
- Are you holding back because you overstretched earlier

Answers to the above could impact your investment pattern from now on.

Apart from the above I would also recommend the following:

1. Limit Expectations – Equities cannot give 40% p.a., it is an unfair expectation. At 40% p.a. Rs 1 lac will be Rs 45 Crs in 25 years. Even in a scenario that they do actually grow at 40% it will not be a straight line as everyday events will affect them just like they did in the last 4 years.
2. Continue Investing – My best investments have been the ones which I made in the worst of times, and for a moment I'm not saying that this is the worst, it could still be some time away but the problem is that if we keep waiting for it, it will come and go and we won't even know. After that we will again regret missing the bus.
3. Be disciplined – Wealth is created by discipline.
4. Don't try and control what you cannot, it only leads to agony. So do not try to time the market but figure out how much of your portfolio should be in risky (read volatile) assets and how much in safer (read steady) assets and stick to it. Markets will continue to be volatile, that's their very nature which you cannot and should not change.