Five Tips for Turbulent Markets

Lazard Australian Equity Team
Volatility is Back

After a long period of benign and steadily climbing equity markets, volatility has returned to markets in the final quarter of 2018. We think more volatile markets may be here to stay. Globally and locally, there are clear and present dangers that equity investors need to be mindful of.

Globally, and in the US in particular, equity market valuations had reached extreme highs at the start of October. The US market had reached a level only seen twice prior in history – in 1929 before the Wall Street Crash and the early 2000s at the end of the tech boom. Combined with the fact that we are currently facing a number of global geo-political issues, along with a cycle of rate tightening, there is good reason to be cautious on global equity indices.

In Australian equities, our outlook is a little better. While there are valuation risks in Australia, they appear to us to be moderate relative to the US market. Should there be a correction in global markets, the lower starting point for Australian valuations may afford domestic investors some relative protection.

Yet local investors cannot afford to be complacent either, particularly with the downturn in the residential housing market looming as the big threat to the Australian economy and stock market (banks, consumer discretionary companies and property in particular).

So how can investors navigate such a difficult environment and prepare themselves for more turbulent market conditions? Here are five things to consider during turbulent markets.

1. Don’t abandon equities altogether

When market and economic environments are less certain, investor return expectations can become difficult to manage. Individuals in such periods can make quick, impulsive decisions based largely on emotions and leave the equity market at the wrong time.

Equities can still play a key role in volatile markets. Successfully timing the equity markets is almost impossible. Many studies have shown that just missing the five best days in equity markets over a year will have a dramatic impact on your overall return. In addition, history shows that many of the biggest one-day upswings occur in the midst of turbulence.

We argue investors need a long-term equity allocation for inflation protection and growth opportunities. Traditional options, like term deposits, bonds, and residential property may not offer enough income to keep pace with cost of living pressures. Equities can over the long-run make a much more attractive source of income.

1 Based on our preferred headline metric, the CAPE Shiller P/E Ratio (the US S&P 500 price-to-earnings multiple on average earnings smoothed over 10 years).
2. Focus on valuation.

While equities can still play a key role in volatile markets, in our view, it is not a sound strategy to naively buy the index. In an expensive market, conducting fundamental valuation research on every stock position we believe is a must. There are many stocks in the Australian market that are priced on unrealistic growth assumptions and we believe that they are candidates for a de-rating.

If a company is overpriced or exposed to one of the major risk factors, our view is that it should be excluded. If an investor cannot find sufficient opportunities for sustainable income and capital growth, then cash should be an option. For example, in our Lazard Defensive Australian Equity Fund we apply a 3% maximum weight in each stock and tilt the portfolio to cash if there are few equity opportunities offering sufficient returns for acceptable risk. Historically, this has seen cash levels rise as the index has grown in value (Exhibit 1). This helps defend your portfolio when markets become overly expensive or volatile.

If you can avoid large drawdowns in choppy markets, you are positioned to compound off a higher base when markets begin to recover.

![Exhibit 1](image-url)

Allocation Between Cash and Stocks is Driven by Opportunity

As of 30 September 2018
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Source: Lazard Asset Management Pacific Co., FactSet
3. Concentrate on sustainable dividend paying companies

If a portfolio owns genuinely sustainable income/dividends, then it should also have more defensive characteristics in down markets. However, you need to be careful when investing for income.

The chase for yield has seen investors seeking out dividend stocks and as a result, companies can inevitably be pressured to ‘manufacture’ yields with complex structures and leverage. Securing a sustainable dividend is more important than simply chasing short-term high yielding and potentially risky companies.

A sustainable dividend is a far greater prize than a quick-fix yield hike. If you can see past a stock’s possibly artificially high current yield, you can find quality companies with sustainable cash-flows and dividends.

Sustainable dividend paying companies will most likely perform better than the benchmark in a downturn due to their capital discipline, cash generative business models and strong franchises.

4. Unshackle your portfolio from the benchmark to ensure ‘real diversification’

The S&P/ASX 200 Index is prone to sector bubbles. In recent years, there have been three instances when one sector has come to dominate the index: technology, media, and telecommunications in 2000, materials and energy in 2008, and more recently, the banks.

The deflating of these bubbles was very painful for investors. Bank exposure in the Australian index has receded somewhat since the peak in 2015 but given the uncertainties around residential property, the market weight of the big four banks of around 23% still represents a major risk. Benchmark-aware investment strategies are naturally going to be exposed to this risk.

We advocate investors to unshackle themselves from benchmarks and seek out ‘real diversification’ by investing in companies that have different sources of revenue that may not be as exposed to the cyclical vagaries of the domestic economy.
5. Compare your fees and watch out for funds using derivative strategies

Investors should always understand what they are invested in. The sophistication of many investment products has grown in recent years, but often this has not been to the end investor’s advantage.

Particularly in volatile markets, investors should be wary of opaque or illiquid structures. For example, many ‘equity’ funds use derivative strategies to effectively convert capital into income. These structures, in our view, are unlikely to deliver an investor’s goal to live off income whilst leaving principal untouched.

In a low-return environment, investors should also be conscious of management fees, which could take up a larger percentage of overall returns. Check what fees (including performance fees) you are paying and how they compare with other options in the market.
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