'Armageddon' is coming, sooner or later

An expert's view on the next market downturn.

Summary: The reaction of investors to market downturns can cause greater problems than the downturns themselves.

Key take-out: It is important that investors don't overreact to short-term fluctuations in the market.

There is a certain smugness about knowing you are right – and when I say 'Armageddon ***is*** coming', like all my fellow economists, I know this prediction is 100 per cent accurate. But experience tells me two things: I can't know when it will happen, and it won't be the catastrophe the headline writers will predict.

At 55, I have lived through – amongst many other 'disasters' – the Cuban Missile crisis, the Vietnam War fiasco, the Whitlam years, the Cold War, Chernobyl, the collapse of the USSR, Iraq (twice), Afghanistan, numerous market breaks … and I am now facing the Trump challenge. What has the market done over this half century and a bit – increased ***on average by 11.68 per cent per annum (based on the US S&P 500 Index in the period 30/11/1962 to 30/6/2018 as per data supplied by Vanguard Investments Australia Limited).***

So, what have I learned as an economist and financial strategist?

Principally, that panic and impatience lead to poverty.

Benjamin Graham is renowned for saying, ***"Individuals who cannot master their emotions are ill-suited to profit from the investment process."*** I would argue that when it comes to investing our own money, just about all of us are prone to fall for a 'tip', a 'hunch' or a headline. We get emotional about our money and we are often irrational – and, if we get lucky because of our tip, hunch or headline investing, we get arrogant. These are all normal human emotions which usually lead us to failure.

So how do I advise clients to avoid these well-known and proven mistakes?

I preach the Gospel of diversification – and patience.

We all remember ***Warren Buffett's message***: ***"Be fearful when others are greedy – and be greedy when others are fearful"***. Buffett's contrarian approach is great – particularly if you have huge pots of available cash to splash around, and if, 'taking a bet' …. and getting it wrong …. won't mean financial disaster. But, for most of us, as 'mum and dad' investors, we can't follow this strategy.

There is another old investment truism, ***'don't try and catch a falling sword',*** which reminds us we cannot tell where the bottom (or top) will be, and the impact of buying (or selling) too early might lead to significant financial pain.

We need to understand and accept market gyrations as normal and healthy.

Part of this is understanding; as everybody's economic hero ***John Maynard Keynes*** said, ***"The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelope our future".*** In other words, there will, at times, be short-term underperformance. It takes time to rebuild after a market break. This can be very painful for retirees, in particular.

To deal with this situation, I typically advise clients to maintain a 'Marinis Buffer' equivalent to two years' worth of income when they are in the drawdown phase. This inoculates their investments from the need for a 'fire sale' of good-quality assets during a downswing just to fund their daily lifestyle.

As investors, we need to accept that we don't know what will happen in the future.

George Soros said, ***"The idea that you can predict what's going to happen contradicts my way of looking at the market".***

And I am constantly amused by ***John Kenneth Galbraith,*** who had a wonderful take on this when he said (in my absolute personal favourite economist quote), ***"The function of economic forecasting is to make astrology look respectable".*** Even the so-called experts get it wrong – often.

So, we don't know what will happen in the future, except at some stage we are certain it will be 'bad'. During these 'bad' economic times, we know for certain that the 'whales' of the investment market will buy good-quality assets at very cheap prices.

The skill of the investor is to separate their emotion from their rationality – to recognise that breaks are normal – and that the investment markets are not linear, and therefore not to panic and sell down, or you will lose a fortune.

A successful investor has a medium to long-term strategy, which involves getting rich slowly. Often, investing is a two-steps-forward, one-step-back, process.

We also need to recognise that, as investors, we are impacted by the human emotions of fear and greed – and do our best to avoid them.

Therefore, I always recommend appointing a reputable team of advisers; whether accountants, lawyers, stockbrokers or financial advisers, to have an emotionally unengaged personal 'board of advice'.

Thanks to 'The Wisdom of Great Investors' by Perennial Investment Partners for most of the quotes used above.

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