Surviving the Crash

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The recent rapid and large increase in the Chinese stock market, followed by a sudden and sharp downturn provides an important lesson for Chinese investors about the proper approaches to stock market investment, especially when using leverage (debt). This article draws from our soon to be published book about personal financial planning in China and discusses both the personal psychological environment in which your decisions must occur as well as the important framework of investment fundamentals for minimizing risk and maximizing return expectations in your portfolio.

Because we are human, natural animal spirits make it difficult to maintain a rational perspective. Mistakes are inevitable. This is particularly so for individual investors. One particularity of China's stock market is that the majority (maybe as much as 80%) of the participants are individual retail investors. The recent stock market advance and then crash has thoroughly demonstrated all kinds of behavioral biases in financial decision-making. With an analogy to some extent appropriate, the recent stock market behavior resembles a group of greedy, short-sighted, and overconfident sheep, herded by an equally overconfident shepherd, rushed to a luscious prairie, but suddenly finding a large and dangerous marsh below. In scrambling to escape, they actually expand the marsh and make escaping more difficult. Due to their lack of experience and fundamental knowledge, many participants in China's stock market may not fully understand correct investment strategy.

Why invest to begin with? While the immediate response may be "To increase wealth," it is much more meaningful for planning purposes to define specific objectives. For example, you might want to assure your ability to fund a major future expenditure, such as your child's education. Or you might want to accumulate more resources to avoid a reduction in lifestyle during retirement. You might want to improve your survivors' financial circumstances in the event of your early death. A more ambitious objective might be to accumulate sufficient funds to achieve financial independence at a young age without relying on income from further employment. These objectives or others all have some priority in your own strategic focus. Those priorities should guide what kind of investment you make and your timeframe for expecting results.

Your choice of investments with the appropriate balance between risk and return involves more than knowing the importance of the goal; you must also factor in how much time you have to permit the required investment returns to occur. This may be the most significant factor of all since the time frame for accomplishing an objective-the holding period for the invest-ment-tends to dramatically change the risk posture of virtually all investments. The expected range of performance substantially narrows as the holding period is extended. This is an especially important consideration for riskier assets, such as stocks.

Long historical data in developed investment markets like the United States strongly suggest that, while the stock market is almost certainly not appropriate for very near-term, crucial goals, it may be the best place to invest your funds aimed toward long-term goals, even very crucial ones. The evidence of history is both that the range of equity returns (volatility) can be expected to decrease substantially over time and that the real (inflation-adjusted) returns of equity investments can be expected to substantially exceed almost all other investment choices. The recent market declines in the Chinese market are not a reason not to invest. It is a reason, however, not to plan to invest just for short term results. If your time frame is long, investing in stocks should be among your most attractive investment choices even with the occasional severe market downturn along the way. Once again, the amount of time available to accomplish your objective is vital to your investment strategy.

There is much more than just historical experience to rely on here. These risk and return results reflect the inescapable long-term consequences of a properly functioning economic system. Equity investments (stocks) reflect the returns required by the *users* of capital. In the aggregate, and over time, the users of capital in any freely operating capital market must achieve results great enough to both pay back the capital suppliers and have enough residual value to make it worth their while not merely to be suppliers themselves. One can't conceive of a durable economic environment involving free capital movements where this relationship is reversed.

Clearly any one capital user can fail, and many do, so it is crucial to recognize that this is an *aggregate* phenomenon. Clearly also, equities' performance advantage could be reversed-for a short time--so this phenomenon should only be relied upon in the long term. Lastly, the historical amount of the return differential is not predictive of the future. Future results, even over long time frames, are not guaranteed to be as good as their historical average advantage but, it remains clear that there will be, there must be, some positive differential in favor of equities-in the aggregate and over the long run.

Once again, the lessons of history and logic are emphatic. If safety of capital is important, and the time horizon is short, then you should select fixed-income investments, with their relatively narrow volatility, notwithstanding their lower returns. Conversely, if your time frame is long, you can confidently tolerate the short-term volatility of equity investments in order to obtain their greater average return over the long term.

Almost as important as that time dimension in reducing risk is the notion of the performance of aggregates. Any one stock can seriously disappoint or even fail completely. Within any category of investment such as common stocks, effective diversification will greatly reduce but won’t prevent fluctuations in value caused by factors that affect the stock category as a whole. Although diversification decreases the amount of downside risk in your portfolio, it will likely also limit the upside gains in the portfolio as well. A deliberately undiversified posture in investments may be aimed toward your "most ambitious/least crucial" objectives. In contrast,

diversification may be essential to increase the safety of investments aimed at achieving your more crucial goals.

You should also consider investing overseas, outside of China. To the extent you can, you should broaden your investment horizons beyond just China. This can be helpful in order to expose you to potentially greater risk-adjusted investment returns, in less volatile, more developed economies, diversified currency risks, and the potential for economic growth in still developing countries at rates greater than China may be able to enjoy in the future. While huge opportunity for economic growth and investment returns will likely remain in China for a long time to come, and while the Chinese government seems committed to do what it can to reduce the degree of the recent severe volatility and might be expected to do so again at points in the future. But you can't rely on that, you shouldn't have to, and you don't really need to. There are other geographic areas of opportunity as well as China and other investment markets perhaps less volatile than China's This is, fundamentally, a diversification notion. Adding international securities to a portfolio has consistently reduced portfolio risk.

A special element of risk in overseas investment is in currency exchange rate fluctuation. This can either soften investment results or magnify them-in either direction. Currency hedging can reduce these potential impacts. However, hedging itself is risky and tends to be expensive. Many investors choose to invest in overseas equities on at least a partially unhedged basis, in the belief (hope) that long-term, broad movement in exchange rates (i.e., the RMB depreciating against an aggregate of foreign currencies) could also provide a further element of return.

Your Personal Investment Attitude

Maybe the most important aspect of effective long term investment begins with your overall attitude. The Chinese capital markets are still new and underdeveloped compared with many other parts of the world. Moreover, many Chinese "investors" view the opportunities more in the nature of short-term gambling rather than patient, long term investment. The recent very high degree of volatility (first up, then down) in the Chinese stock market, for example, is probably both a reflection of this "casino" mentality by many participants and is the result of the large impact of many participants' short-term transactional perspective. Moreover, governmental intervention, while appearing to alleviate some of the most damaging effects of the recent downturn, can serve to merely postpone investment markets achieving more realistic valuations and make the Chinese market less attractive to overseas investors. The fundamental behavior and reasonable expectations of Chinese investors are, in the long run, the best assurance of the dependability of market values. The Chinese markets becoming more stable, less volatile, will very likely occur over time as a result of many more people developing a mature perspective. You can benefit from this eventual development by beginning your investment program with a very long view in mind.

Timing

Timing can be the greatest stumbling block in actually implementing your investment strategy. Investment markets go up and down, sometimes by large measures in very short time frames.. Clearly, it would be optimal, if at all possible, to buy and sell at precisely the right times. But, investment returns are generally random and thus unpredictable. One big mistake could outweigh many prior successful moves.

Given the long-term upward bias of most equity investment markets, both theory, and experience in the developed markets, argue strongly that the best course of action is to put funds to work as soon as they become available and then to maintain a consistent investment strategy, avoiding the fear of investing “at the wrong time” and the temptation to retreat from the strategy when circumstances look frightening. Nevertheless, recognizing the psychologically difficult proposition of committing funds to risk all at once or keeping everything invested until just before a need to liquidate to fund some spending objective, many people choose a *gradual* approach, putting parts of the whole in place over months or quarters. This "averaging" into investments and, eventually, averaging out is, for many people, a natural event. It is a consequence of how investable funds become available (monthly or annual net cash flows from earnings, for example) or how funds will ultimately be consumed (periodic withdrawals from a portfolio to fund living expenses),

Investment Leverage

Much of the recent run-up and then run-down in the Chinese stock market has been attributed to the use of debt, or margin borrowing, to exaggerate both the upside of the opportunity beyond the economic fundamentals and to exaggerate the downside as equity values began to disappoint. By establishing a “margin” brokerage account, you can buy investments with only a down payment. This makes good sense ONLY

- if you borrow only a small fraction (no more than 50%) of what the total cost of the purchase is
- if you are buying diversified assets (not just one stock) and
- if your expected holding period is relatively long, say, at least several years

The benefit of using margin can be substantial and the risks manageable if the returns on the investment of the borrowed funds exceed the costs of the borrowing. This is very likely, but only over time. Borrowing a multiple of your down payment, or purchasing only one stock, or hoping to sell very soon, and especially if you commit all three of these errors, can be a recipe for disaster as many Chinese investors recently discovered.

For some sophisticated uses in wealth management, debt can be a matter of opportunity. It is often advantageous to choose to use leverage-by margin borrowing or by deliberately keeping a large home mortgage in order to have more gross assets to invest.

Debt management for high-net-worth, high-income individuals, unlike persons with more modest financial resources, can involve acquiring and maintaining appropriate levels of opportunistic debt. The strategic use of debt (debt-financed business enterprises, durable margin loans, and interest only mortgages), for example, can free up additional capital, within the framework of a comprehensive financial plan, to provide wealthy persons the opportunity to maximize net returns and to minimize total costs.

Borrowers of capital must hope to earn returns greater than the principal repayment and interest they pay to lenders; and in the aggregate, over time, they do. Otherwise there would be no incentive to borrow and invest - instead only to lend - an impossible situation on any durable basis. Borrowers, as a very large group, can expect to earn a higher rate of return because they invest the borrowed capital in opportunities that are riskier (higher returning) than the lending of capital. Of course, this only works over time and across many borrowers. Not all investments are successful, some borrowers default.

In other words, over the long term and in the aggregate, equity investments must outperform debt used to acquire them. If you have the ability to withstand the short-term risks and if you diversify the leveraged investment holdings, the benefits of leverage can be compelling.

So, margin is a legitimate, and if used properly, only moderately risky means of augmenting portfolio results. The controlled use of margin can achieve returns greater-perhaps much greater--on average and over time-- than the margin loan costs, especially if the investment returns qualify for low rates of tax on long term investments.

While using margin increases volatility and increases downside risk, if you are a long-term investor, you are very likely to achieve a better return by using margin leverage. If you can expect that a spread of about 3 percent between the margin cost and average diversified equity portfolio returns (as demonstrated over long time frames in developed markets) will endure, each 100,000RMB increment of margin should yield a net advantage of about 3,000RMB per year.

Consequently, you can legitimately consider a commitment to margin debt at a level that is both financially affordable and psychologically comfortable for you. For example, to keep the downside risk within a tolerable range in the short term, you might keep the amount of the margin leverage to no more than one quarter of the size of the margined portfolio. While the law might permit initially borrowing a greater amount, a self-imposed limit of 25 percent would avoid margin calls or forced sales for a market decline of as much as 50 percent. This size of market collapse has never occurred for broadly diversified portfolios in developed markets.

While the market is still volatile and investors' sentiments need to calm, it is foreseeable that some people who went through this battle or were deeply shocked as an observer, are now disheartened and may decide never to touch any stock or risky investment ever again. Not long ago when the stock market soared, while optimistic news and information were abundant, short-sighted participants chased the stock market into a bubble. Now just after the crash, as

the painful memory is very deep and vivid, many people are very reluctant to invest in the stock market. Like two sides of a coin, this overemphasis on short-term losses is again caused by the same short-sighted gambling mentality that contributed to the bubble. Consequently, if you choose too conservative investments or even just hold cash now as a result, you not only will miss out on the long-term superior performance of stocks, but also likely not keep pace with inflation. However, if you take advantage of this opportunity to adopt the correct attitude and take a diversified and long term investment approach, continuing to participate in the stock market will likely be the best way to survive the crash.

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