INVESTING STRATEGIES

Why the investment losses in 2022 could be minimised

BY GREGORY JONATHAN SEE

BLOOMBERG

Coca-Cola drinks sold in a supermarket in Mongolia. If an investor bought shares of The Coca-Cola Co in the bull market of 1972–1973 and held them till the end of the century, they would have made compounded annual returns of 12%

2022 proved to be a challenging year for global equity markets, with significant declines seen across various major indices. After adjusting for dividends, the S&P 500 yielded –18.1% while the Nasdaq 100 index saw a decline of –32.4%. Meanwhile, the MSCI Asia-Pacific ex-Japan delivered a return of –19.4% and the Hang Seng Composite Index also experienced a loss of –12.6%.

Could active investors have acted defensively ahead of the declines, or should such declines be treated as inevitable in one's long investing journey? This article seeks to shed some light on the question.

Firstly, investors or shrewd traders need to clearly differentiate between investing in productive assets and speculative assets. Productive assets produce something of value (businesses generate earnings, real estate generate rental income, farmlands produce wheat, corn and so on), versus speculative assets that produce nothing (gold, cryptocurrencies and so on).

You can use a discounted cash flow approach to value a productive asset, by discounting its future net cash flows to present value using an appropriate discount rate. If conservative assumptions are being used and your estimated value shows a decent gap above price, you may choose to purchase the asset. However, there is no logical way to value the worth of a speculative asset and thus, it is impossible to determine whether it is currently under- or over-priced in the marketplace.

A long-term investor's aim should be to achieve a significant amount of compounded wealth after a prolonged period, say 30 years. Compounded at 12% per annum, $1 million becomes $10 million after 20 years, but it becomes $30 million after 30 years. To reap such compounded benefits, it is vitally important to avoid the devastating losses seen in many cryptocurrencies and low-quality listed companies in 2022.

Consider the following headlines/events that appeared in 2021 suggesting the investing climate had become overly exuberant and speculative.

"I could potentially see Bitcoin become the 21st-century gold" (A particular prominent European investment bank promoting Bitcoin during its run-up from US$9,000 to almost US$70,000 in 18 months). This was irrational enthusiasm all round, built on the back of self-fulfilling expectations. Whenever you read about sell-side analysts offering free advice and promoting a speculative asset, especially after a huge run-up in the underlying price, consider the motives of the writer very carefully.

The US meme stocks run in 2021. Poor-quality companies (with no structural competitive advantages and mostly loss-making for many years) doubled or tripled in matters of weeks or even days. Or many loss-making internet-based businesses were valued based on sales or total addressable market. (The higher up the income statement figures that you need to use to justify the valuation, the more speculative the environment has become.) Extreme greed is manifested when price actions grab the market's focus, while underlying business values take a back seat.

We must not forget the advice given by Benjamin Graham: "It is not the buying of high-quality companies at the top of a market cycle that will result in permanent losses, but the buying of poor-quality companies temporarily disguised as good ones during the top of an economic boom." After all, even if you had bought **Coca-Cola** stock in the bull market of 1972-1973, you would have made compounded annual returns of +12% if you had held it patiently till the end of the century.

We must also not forget the fact that in 2021, various early-stage venture capital funds successfully raised billions of dollars in a short span of time (often subject to opaque assumptions and misleading valuations/marked to opinions versus marked to transparent market prices for listed equities). These are signs of investors ignoring the importance of certainty in investment values due to the prevalence of cheap and easy money.

Quantitatively, although broad market valuations were not considered exorbitant in 2021 (S&P 500 earnings multiple was 25x at its peak in 2021, assuming conservative forward earnings estimate), qualitatively, we can safely conclude that the investing climate had become too hot and should warrant extra prudence.

In one's long investing journey, it is important to often think and act in a somewhat counter-cyclical manner. Assuming you have purchased the right kind of high-quality businesses to own for the long haul, you must then always maintain a rational mindset. At the very least, even if you decide to sell some holdings to purchase small amount of speculative assets (to scratch that gambling itch), you should do so only when the investing climate is cool and certainly not after huge run-ups in underlying prices, and not at a time when your peers are enthusiastically talking about it. As Warren Buffett once said: "The best investment moves are usually greeted by yawns and not by applauses."

So how can we judge which part of the cycle or what kind of investment climate we are in?

Our fund has always found the investment philosophy of Howard Marks, the co-founder of Oaktree Capital, to be very clear and effective.

Think of the investing climate or cycle as a pendulum that swings from end to end. Usually, the pendulum fluctuates near the midpoint (fair market values). However, occasionally, it swings to the left, representing a depressed and gloomy environment that is generally marked by low valuations; or to the right, representing a buoyant and exuberant environment that is generally marked by high valuations. At our fund, we propose using both quantitative metrics and qualitative observations for this sort of analysis.

Quantitative metrics

We can use several valuation metrics to get a general sense of how expensive (hot) or cheap (cold) the market has become. We can gauge valuations based on historical and/or absolute terms (using common sense), bearing in mind that estimated intrinsic values should be a range of values and not a specific static number. What we then should carefully observe is whether the market has priced the business way out of either end of the range. For instance,

- High PE ratios on stocks, low yields on bonds, high capitalisation rates on real estate, and high cash flow multiples on buyouts relative to historic norms could indicate low prospective returns.
- Conversely, the reverse is true during a market collapse, when assets prices tend to decline to bargain valuations.

Qualitative observations

- Be on high alert and observe how other investors are behaving. Are they euphoric or terrified? Is the sector red-hot or depressed? What is the level of interest shown by sell-side analysts? Also, keep a close eye on conventional media headlines. Where we stand in the cycle influences the tendencies or probabilities of future events, even if it does not determine these events with certainty. All other things equal, when the market is high in its cycle, a downward correction is more likely than continued gains, and vice versa. Although it does not have to work out that way, we should think and act probabilistically.
- Gauging our position in the cycle does not tell us what will happen next, just what's more or less likely. But that's a lot.

Inevitably, cycles will happen to us again and again, and how we respond to them is key. It is imperative for us to behave in a way that is appropriate for the market climate. How should we consider positioning a portfolio as the market moves through its cycle? There are two primary sources of investment errors that investors face daily: 1) risk of loss (error of commission); and 2) risk of missing opportunity (error of omission).

When the market is high in its cycle, we should emphasise limiting the potential of losing money (that is, reducing the error of commission). When the market is low in its cycle, we should emphasise reducing the risk of missing opportunity (that is, reducing the error of omission).

Hence, it is always the question of balance between aggression and conservation, between attacking and defending. To help clear your mind, imagine travelling into the future and looking back in time. Try asking yourself the following question: In 2025, do you think you are more likely to say, "Back in 2021 I wish I had been more defensive"; or "Back in 2022, I missed the opportunity of a lifetime to buy XYZ as I was occupied with the mental burden of coping with the crushing losses in low-quality businesses"?

What you think you might say a few years down the road can help you figure out what you should do today. Visualise forward first; then rethink and readjust your stance now. As Oaktree Capital's Marks once said: "We may never know how the future will be like, but we better have a good idea where we are."

Our suggestions are by no means encouraging investors to sell out whole portfolios when the investing climate is exuberant and buy back when it subsequently turns cooler. This is poor investment advice to say the least, as 1) cycles tops/bottoms are impossible to predict consistently, hence it is usually futile to time the market; and 2) most human characteristics are inherently pro-cyclical and pro-herding. Hence this makes it difficult to buy aggressively when all seems gloomy and depressed.

What we do encourage is, at least seek to price the market based on valuations and not to act in a silly manner that may lead them astray from achieving long-term compounded wealth. E

Gregory Jonathan See is CEO and CIO of AGT Partners, an MAS-registered fund management company employing fundamentals-driven, active-trading and quantitative-driven strategies. In 2022, the fund managed by AGT returned a gross return of 14%, or 11.7% net of fees. Nothing mentioned in this article should be construed as investment advice nor of recommending the attractiveness of the fund managed by AGT