Bailout blues: lessons learnt from the GFC

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Clockwise, from top left ... Martin Conlon, Ian Silk, John Dani, Matthew Sherwood, Laura Menschik and Paul Taylor.

Annette Sampson asks a range of experts what they learnt from the global financial crisis and what their strategies are for coping with the latest volatility.

'I*f history repeats itself, and the unexpected always happens, how incapable must Man be of learning from experience."* - George Bernard Shaw

There's an old Hindu proverb that says, ''No physician is really good until he has killed one or two patients''. OK, so that's a bit extreme. But when it comes to investing, the best lessons are often learnt when things go wrong.

Any fool can look like a genius in a rising market but successful long-term investors are those who pick themselves up again after losing money and invest smarter.

For most of us, the global financial crisis has provided the biggest investment learning experience of our lifetime. Australian shares fell 55 per cent from their peak, far in excess of the falls in 1987 and the early 2000s. And with widespread fear and markets still swinging from one extreme to another, its fallout continues to wreak havoc.

Money asked a range of experts three big questions:

What did they learn from the GFC?

How did it change their thinking?

How has it affected their approach to the current volatility?

MARTIN CONLON

Head of Australian Equities, Schroders

''[I learnt] that debt and leverage are not paths to prosperity. It doesn't matter whether the entity is a company, government or an individual, expenses cannot exceed income - this revelation is still proving too difficult for most governments to understand. We believe the extended period of easy credit and rising asset prices, largely the result of

easy credit, removed focus from genuine productivity gain as being the only real way to create wealth. Bailout packages, expectations that government spending will create jobs and artificially cheap money the world over, are signs that this lesson has not been learnt.

''The other key lesson surrounds complexity. Almost everything about financial markets has become overcomplicated. The importance of simplicity should not be underestimated. We have always had a relatively conservative attitude to financial leverage [but] the GFC has served to reinforce this attitude.

''Financial engineering does not create real value and we are continuing to avoid companies that think otherwise. Our attitude to businesses and the financing of them is to reinforce the simplicity theme. The most important factor in running a business is to invest capital wisely and to generate a reasonable return on it, in cash!

''Volatility, in our eyes, has never had anything to do with risk. Volatility stems from changes in human behaviour, risk aversion and other factors, which have little to do with actual risk. Our objective is to do our best to avoid the noise and panic and try to focus on the underlying dynamics of the businesses we're buying, the sustainability of the cash flows coming from them and how much we're paying for them.''

IAN SILK

Chief executive officer, Australian Super

''The biggest thing [the GFC] taught me is that when there is a big shock in investment markets, it reverberates through all markets and diversification is not an absolute protection. Cash is really the only safe haven in dire markets, where there is a contagion effect in most investment markets. These shocks are rare and normally diversification does provide the intended benefits but when you have isolated dramatic events like the GFC, it provides limited benefits.

''[The GFC] hasn't changed our approach to diversification because you can't manage money thinking there will be a GFC all the time. You'd have all your money parked in cash all the time.

''What it has done, hopefully for everybody, is to provide a word of caution of how easy it is to lose money and for value destruction to occur. So there's a greater level of vigilance and concern for the downside. You could seek the security of cash all the time but that has its own longer-term costs in terms of returns.

''There is a greater awareness of how much money was lost during the GFC and how investment markets are fickle and volatile beasts but sometimes you have to overcome that caution to achieve the best long-term outcomes. There are people who predicted the GFC and some predicted it for years before it happened. They didn't perform in the preceding years and haven't generated the returns they could have.

''[The lessons from the GFC] aren't impacting terribly much on how we're handling the current environment. We're likely to experience volatile markets for some time and we're directing our cash flow into cash but holding on to the bulk of our other assets. We're not in the business of wholesale selling. Our caution is dictated more by the current environment than what happened in the GFC.

''Our reluctance to invest at the moment is more to do with the medium-term outlook for investment markets. But the GFC was only three years ago and if it's not still imprinted on people's minds, something is wrong.''

JOHN DANI

National manager advice development, ipac securities

''What I learnt is the extent to which our emotions are intimately linked to money. I had never witnessed such an emotional impact before. We've seen downturns but the GFC really revealed how much falls in wealth and large market swings can cause anxiety and feelings of utter helplessness. It leads to things like paralysis and anger, which in turn led to decisions being made based on fear and greed.

''Even though people may have had a rational understanding in the depths of the GFC that things had become crazy and there would eventually be a recovery of some description, the emotion was so great it totally overwhelmed that rational decision-making, resulting in total paralysis or just capitulating to what was happening.

''It doesn't so much change my attitude as to reinforce the importance of cash-based investments and reliable income-generating assets, particularly for people nearing or in retirement. There's a need for investors to be more proactive in how they prepare their portfolio so that it is more resilient as they near retirement. The days when you had your money in a growth portfolio and, six months before retirement, decided to review it or see a financial planner, are gone. You need to start building in protections at least five years before retirement.

"The big thing that has changed at ipac is that we're using technology much better to keep clients informed. What the GFC showed us was the need to cut through the noise and give people the information they're yearning for in times of volatility. For me, personally, there are things that stand out. One is that need to be proactive early on when looking to retirement. The other, given my age and the fact that I'm still in the accumulation phase, is that, if anything, the GFC has strengthened my own resilience. Despite all the doom and gloom, things did bounce back. It wasn't without some pain but, for me, it has provided a bit more courage to act and not be paralysed when things go wrong and to participate in the market a bit more. It's not about being flippant or super-aggressive but, even during the current volatility, the GFC experience can provide the strength to maintain a medium- to longer-term view."

PAUL TAYLOR

Portfolio manager, Fidelity Australian Equities Fund

"The big lesson for me was the need to focus on balance sheets. Equity analysts tend to focus on the profit-and-loss statement while fixed-interest analysts focus on the balance sheet but during the GFC, the balance sheet was the only thing that mattered. The profit-and-loss means nothing if a company has too much debt, so you need to be on top of both. Companies that had low debt levels and were well structured benefited in two ways during the GFC. Trying to raise capital was very difficult during that period but they didn't have to worry about it and they were also in a position to invest.

"The other lesson was the importance of liquidity, as it can dry up very quickly and if you need to raise cash you can get caught, especially in mid- and smaller-cap stocks.

"[The GFC] hasn't overly changed my thinking, as Fidelity has always focused on these things anyway. But at times like the GFC you realise, 'OK, now I understand completely why we do this stuff'. It is when it pays off.

"There are a few things [I learnt] from the GFC that come back dealing with the current volatility. One, of getting advice from people who have been around for a very long time and making sure you're not looking at the screens continually. You can get caught up in market noise and psychology. When things are volatile, it's often better to get away from the screens and go out and talk to companies. You avoid getting caught up in the emotions of the market. You also need to have the discipline to follow your investment processes day in and day out, whether things are good or bad, and focus on investing long-term rather than trading in and out of stocks."

LAURA MENSCHIK

Financial planner, WLM Financial Group

"One of the things I learnt is the value of going back to basics in terms of why people are investing, their time-frames, cash flow needs - all the preliminary stuff. Leading into the GFC, most people were comfortable with the strategies they had been following but when something like that happens the comfort levels are suddenly not there. What it taught everyone is what they thought they felt comfortable with could become uncomfortable in changing circumstances.

"You need to go back to the basics of your needs, aspirations, basic investment philosophies and strategies and work from that. Hindsight is a wonderful thing but, in general, income and liquidity are the main things you work with - especially in retirement. What do you need to live on? Do you have emergency money if you can't work? How quickly can you access it?

"There's a much more sober attitude generally now. People are paying down debt and being more responsible. They're more aware and paying more attention [to their finances]. They're probably holding a bit more in cash and fixed interest than before because things have been more volatile.

"We're looking closely at what people have and whether what they have is adding value. If they're in international funds, for example, have the managers been earning their fees? If they're in term deposits or cash, are they still getting a good return on their money? If they're holding shares that have fallen in value, would they be better to sell and put their money in other shares that have better earnings potential rather than hanging on hoping they'll come good? The GFC has emphasised the need for constant review. That doesn't mean you should be reacting to every share price movement but you can't set and forget. There are still opportunities out there but it comes back to discipline. People are much more inclined to stick to strategies like dollar-cost averaging in this market."

MATTHEW SHERWOOD

Head of investment market research, Perpetual

"I think there were four key lessons to be learnt from the GFC. The first was the importance of balance sheets - never invest in a company without understanding its finances. That is probably the easiest and by far the best form of risk management. In every downturn, the companies with the highest debt and weakest balance sheets fall the farthest.

''The second lesson is the importance of income. In the 25 years to 2008, capital gains were dominant, providing about three-quarters of total returns. It got to the point where it almost seemed as if dividends didn't matter. People forgot that dividends are more reliable and an important risk-management tool. The third lesson was that the quality of an asset is important and that sometimes in bull markets the lowest quality rises the fastest. And the fourth is valuations. Investors never want to pay too much, regardless of how good an investment is. Quality companies don't always make quality investments because valuations can be too high.

''I think investors generally have become a lot less risk tolerant as a result of the GFC. They've probably gone to the other end of the spectrum, where all they want to hold is cash. Perpetual hasn't changed how it picks stocks and still looks at the fundamentals.

''People all want to hold term deposits because they're backed by the government and provide a higher yield but over time, if you're interested in income, the sharemarket provides by far the greatest income growth. Since the oil crisis in 1974, when shares fell by 59 per cent and investors thought the world was going to end because energy prices had quadrupled in six months, Australian shares have produced income growth of 21 times your initial investment. Listed property trusts provided 14 times income growth, cash three times and gold, none. People are nervous about the European outlook and justifiably so but they're making the opposite mistake to the one they made before the GFC. Going into the GFC, the mentality was that share prices were rising and who cared about risk? Now people are highly risk averse. History will prove that one is right - but who knows which one?''

Read more: http://www.theage.com.au/money/investing/bailout-blues-lessons-learnt-from-the-gfc-20110920-1kivj.html#ixzz1YYPnHDxB