LESSONS FOR RETAIL INVESTORS FROM 2022

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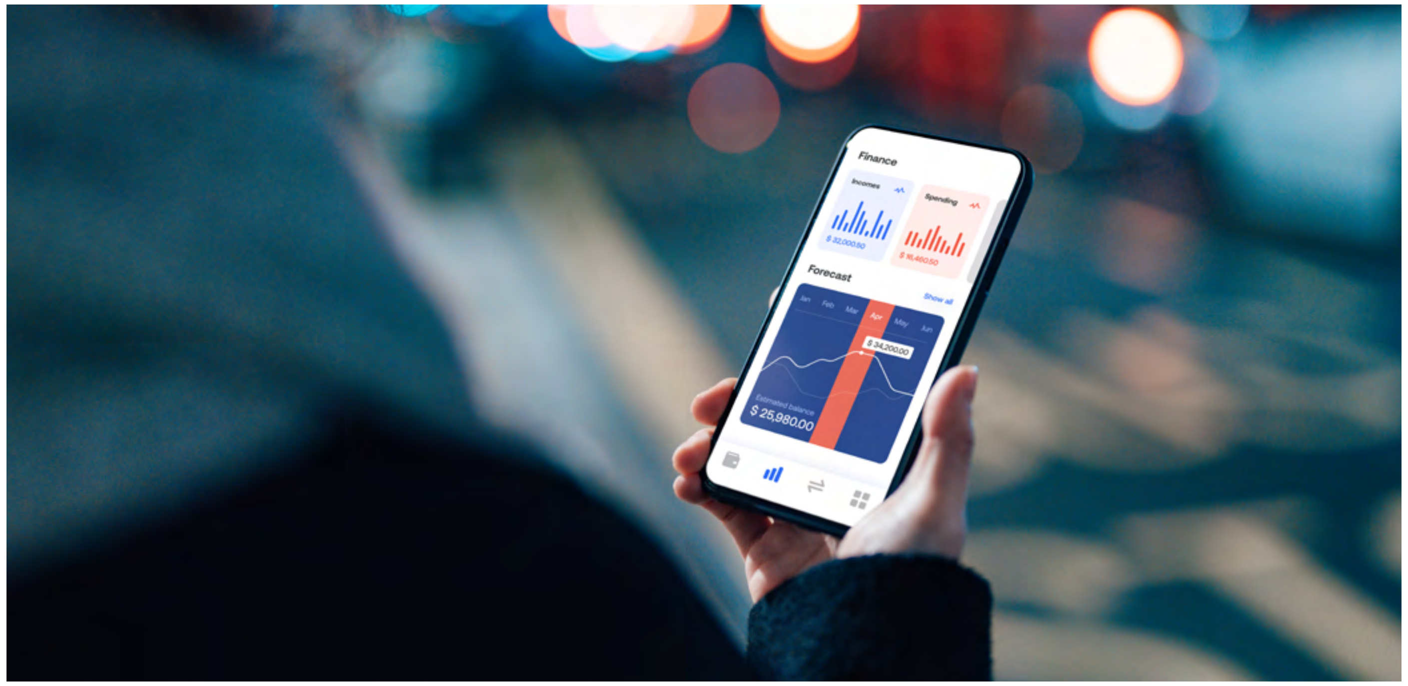
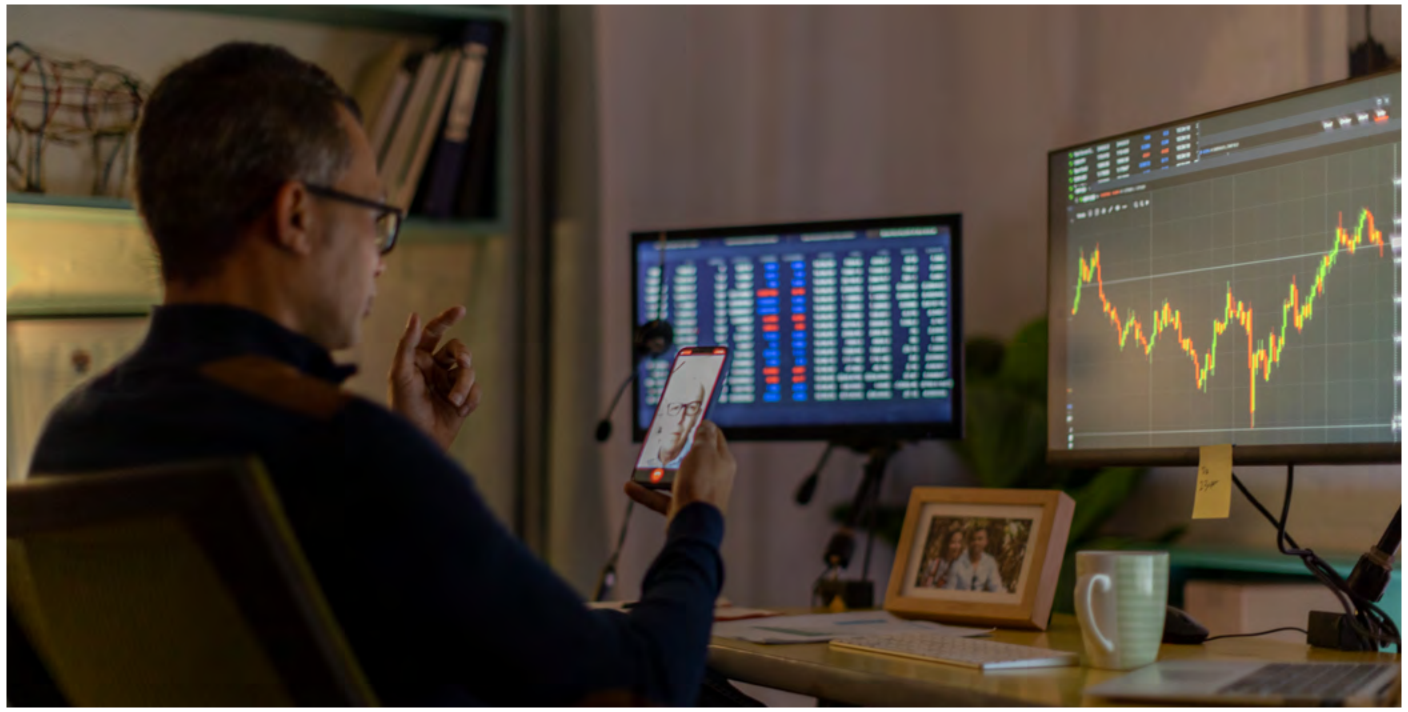
Last year was a brutal one for investors, and one that could easily best be forgotten. There is plenty of data to support this, but perhaps one of the best examples was that the traditional 60% equities/40% bonds portfolio had its worst annual return in the past 100 years. However, as with other aspects of life, but it can seem even more so for investments, it can be the most difficult experiences that provide the most valuable lessons. Here are five lessons that we think retail investors can learn from last year as we enter 2023.

1. Diversification

The probability is that almost every investor already knows that diversification is crucial in order to minimise portfolio risk and optimise returns per unit of risk taken. However, there can be significant differences between theory and practice. It is unfortunately quite common to see investors believing they have sufficiently diversified their portfolios from a geographical perspective, yet in reality, for instance, there may be too much over-commitment to the US while ignoring much of the rest of the world, perhaps because that may have worked well in the past. Similarly, some portfolios might initially seem well-diversified when looked at "top-down", although upon drilling down there can be extreme exposures to specific market segments, or numerous sub-sector bets that are additive to a huge exposure to a particular broad sector, for instance, an over-concentration in large-cap technology growth stocks in equity allocations or far too much emphasis on long-duration bonds in fixed income portfolios. Such mistakes can adversely affect portfolio performance, perhaps seriously, and turn a bad year into a dreadful one. Therefore, to achieve better risk-adjusted returns, diversification has to be "genuine", with exposures balanced between styles, sectors, themes and asset classes. Finally, the inclusion of so-called "alternative" investments (e.g. hedge funds, commodities or private equity) should not be ignored for those clients with the requisite risk profiles.





2. Rethinking the Use of Leverage

Leverage (sometimes called "gearing") is a tool that one could liken to handling fragile items when moving house; it must be handled with extreme care, otherwise precious belongings can break into small pieces. Investors had a glimpse of the kinds of drawdowns possible on leveraged vs non-leveraged investments during the March 2020 crisis. Then, contrary to 2022, markets staged a "V"-shaped recovery. The main rationale for utilising leverage, the potential doubling or even tripling of investment returns, has to be carefully assessed in terms of the potential for larger portfolio drawdowns, the possibility of margin calls and ways to handle them, and of course the cost of funding. These must be analysed prior to the initial application of leverage, rather than during possibly turbulent periods of market volatility. A careful assessment is likely to show that leverage is not appropriate for many investors, including some apparently willing to take high risk; in reality their capacity to bear such risk may simply not be there. On the other hand, leverage may well be appropriate for use by sophisticated investors who have carefully considered the above-mentioned factors. They may be able to profitably employ leverage in exceptional and/or tactical circumstances to their long-term advantage, benefitting from short-term market dislocations.

3. Controlling Emotions

It is well known that when investing, fear and greed are the two main emotions that often come into play, which can adversely affect rational decision-making.

Greed can cause an investor to become overconfident, and to make reckless decisions in the pursuit of greater returns. This can result in taking on unnecessary risk, and making investment decisions leading to losses. We saw this in a systemic sense during the "anti-Covid" 2020-2021 central bank-induced "everything" rally, when, with the benefit of hindsight, excessive amounts of liquidity created market bubbles that provided the basis for the 2022 bear market. It was a period in which many would-be investors, the majority of whom were working from home, opened brokerage accounts for the first time. Short-term bets tended to be made on equities in the pursuit of a quick profit, ignoring Benjamin Graham's quote, 'The individual investor should act consistently as an investor, not a speculator'. These new investors often did not seek investment advice, or apply a holistic approach to their investment activities.

On the other hand, fear can cause an investor to avoid making a potentially good investment, passing up an opportunity for growth. We have seen this occurring in each and every recent market correction, especially the more severe ones, such as the one that played out last year. Only a handful of investors thought it was a good time in October last year to deploy cash into equities, despite some valuations coming down to earth in certain parts of the market. In addition, many retail investors saw the opportunities emerging in bond markets in the second half of last year, especially in shorter-duration, higher-quality issues, but kept postponing their decision to buy because of a factor already discounted by the markets: that the US Federal Reserve would increase rates at its next meeting. In both cases described above, investors were surprised and felt they missed out after seeing a couple of positive inflation readings translating into a huge rally for bonds, and some parts of equity markets.

4. Managing risk

A famous saying initially attributed to John Maynard Keynes, and later to Garry Shelling, reminds us that 'Markets can stay irrational longer than you can stay solvent'. Understanding and managing risk are crucial to successful investing. We've touched upon the importance of managing risk in leveraged positions, but some similar logic applies to non-leveraged positions, too. Investors should not pursue the highest possible returns ignoring the risk they would have to take to realise that return. Indeed, many investment discussions start with the phrase, 'I want X% return', with that number often being unrealistically high, and not even related to the current risk-free rate. This misguided starting point can lead to a badly designed high-risk portfolio with excessive volatility and losses. The problem is, they find out only when it is too late, and the damage has already been inflicted. On the other hand, we also occasionally find that some investors take less risk than prescribed by their risk profile, negatively affecting the realised returns of their portfolios in the long-term.

On a separate but related note, we should never invest funds that will or could be needed in the immediate months or years ahead. Doing so could mean getting trapped in a bad market environment, resulting in having to make some difficult choices: liquidating at a loss; or having to find alternative funding sources (if that is even possible). Last year's market conditions certainly tested investors' ability to manage risk in their portfolios.

5. Rethinking the Concept of "Income"

Investing with the aim of generating income has traditionally been one of the favourite investment themes for GCC-based investors. Many readers might ask, 'What could be wrong with that?'. Well, for starters, it is a fact that in many cases income is not actually

required from investment portfolios. Many investors already have multiple sources of income, including a monthly salary and/or rental income. So then why do so many people who are not short of income apparently approach investments with income in mind?

One deeply rooted perception suggests this is the only way to approach investment opportunities, which is of course fundamentally wrong. Assuming the income is recurring, investors are much better off if they are able to reinvest most or all of their investment income, i.e. capturing the power of compound interest. Taking a simplified example and ignoring other factors, if we invest AED 1 million today in a well-diversified portfolio that has an expected annual return of 6% for 20 years, we would end up with AED 3.2 million. On the other hand, if we invest AED 1 million in a 6% income-generating focused asset, with no re-investments, we would end up with only AED 2.2 million (original capital, plus total interest). This AED 1 million difference is solely the effect of compound interest, and many investors miss out completely on that.

Moreover, by only focusing on what level of income an investment may provide, investors often ignore the characteristics and riskiness of the investment strategy used. Indeed, just as we saw in 2022, when markets enter "risk-off" mode, liquidity tends to dry up, adversely impacting the market value of an investment. Does it really matter that we get a 7% dividend yield or coupon if our year-to-date total return (including the 7% income yield) stands at -25%? And if our selected strategy was paying out as income, not true underlying income but past capital appreciation from the equity market, when times were good, what happens if 2020-2021 market conditions are not repeated any time soon? It is these kinds of questions that remind us of another famous saying: 'There's no such thing as a free lunch'. Embracing a high yield/income investment strategy exposes us to risks that may negatively affect the capital value of our investment, which is what matters most at the end of the day. On the other hand, investing in income and/or high-income generating strategies may be appropriate for those who have a genuine income need, matching the investor risk profile.