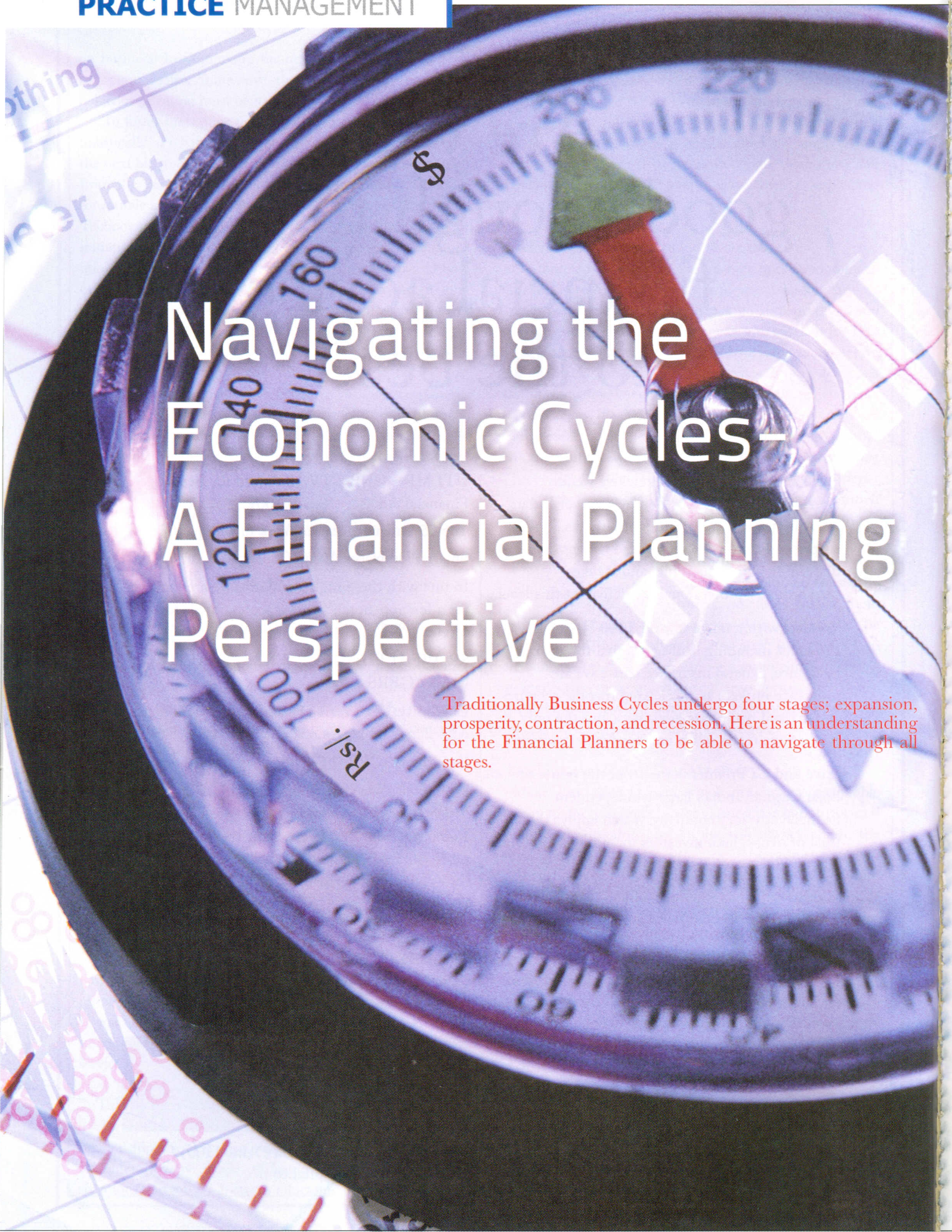

Navigating the Economic Cycles- A Financial Planning Perspective

Traditionally Business Cycles undergo four stages; expansion, prosperity, contraction, and recession. Here is an understanding for the Financial Planners to be able to navigate through all stages.

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As this article is being written, we are possibly coming out of recession. BSE Sensex is ruling above 17000. There is optimism all around. Just a year back BSE Sensex was at sub 10000 levels with very little hope of such rebound. Corporate profitability numbers are going up. IIP numbers are showing signs of increased demand. While there are still doubts about a major revival in the USA and Europe in the near future, Asia is surely witnessing signs of growth and the momentum is looking good. One reason for improved momentum is the stimulus given by governments all over the world. As such, it needs to be seen how things shape up once these stimulus packages are rolled back.

Today, we term the last year and a half as one of the worst recession periods the world has witnessed. We have gone to the extent of comparing the current recession with the great depression of 1930's. Each time we face a crisis situation, we tend to find a solution to it, so that we do not face the same situation again.

What are event risks?

In the financial world, a situation which can have a negative implication on an investment portfolio can be termed as an event risk. For e.g.: war, political uncertainty, recession, terrorist attacks like 9/11, Dubai world payment crisis, unexpected rise in inflation, bankruptcy of the global corporations, etc., can all be termed as event risk. They can all have devastating impact on an investment portfolio. And one peculiar thing about most event risk is – it comes without warning for most people and these events are difficult to time.

The current recession (or the last recession) can be termed as an event risk just like many other events that keeps investors and fund managers, the world over, on their toes.

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Event risk and Financial Planning

Financial planners act as a fiduciary for their clients. It is a planner's responsibility to take care of their client's wealth and help them to achieve their financial objectives. As such, it is expected that they should possess the necessary skills to ensure decent returns on client's portfolio. However, how practical it is for a planner to know about event risks before they happen, when large corporates and the best minds in the world having all the information needed and crunching numbers 24X7 are unable to identify with accuracy the happening of such events. One should try to understand the event risks in detail before we try finding out a solution to handle such situations.

Can we eliminate the events and thereby event risks?

No! It is impossible to eliminate happening of unwanted events. Can we ensure that there will be no terrorists attack again? Well, the possibility of events like 9/11 again in US may be low, but somewhere, sometime we may witness these attacks again. Can we eliminate another Tsunami happening? No we can't. Can we ensure that there will be no war again between two countries? Well, we can sign hundreds of treaties and make promises, but it may happen sooner than one expects. Can we eliminate the failure of a big corporate in future? Things change and big corporates will fail in future too.

Can we predict such events?

Now, if we know that we cannot eliminate events from happening, the second question is whether we can predict these events or not. If we can really predict these events, do they actually fall in the category of event risks? For e.g. if we know that there will be a terrorist attacks at "x" place on "y" date and time, we can take precautionary measures to ensure that the attacks do not take place or at least the impact of the attacks could be controlled. If this happens, it may not be called an event risk. If any thing is known in advance, either it won't lead to an event risk or it can be said that the event risk occurred at the moment at which it became known that an event is expected to take place. For e.g. the expectation of a major corporation going bankrupt will cause more stir in the market place (and lose billions of dollars in market capitalization) than its actual bankruptcy, which can happens months later. In reality, although the actual event of bankruptcy may happen months later, the event risk transpired at the time of market expectation of the eventual bankruptcy happening. In this case, the event risk is the expectation of the event happening rather than an actual bankruptcy. It is therefore to be observed that unwanted events would always keep on happening.

Impact of event risk

Various negative events can put client finances into disarray. 10 years of earnings in equity market can be wiped off in 1 bad year. Swings in interest rates can play havoc with fixed income instruments. Loss of job, death of earning member, major illness, unplanned expenses etc. can create emotional as well as financial imbalance for people.

As long the results are positive, we take the credit ourselves. When it proves fatal, we blame the economy, the government, and if not anything else, we blame our luck.

Table 1: Performance of SENSEX during Jan '08 to Mar '09

Period	Sensex Level
2nd Jan 2008	20465
31st Mar 2009	9708
Absolute return during the period	-52%
Annualized return during the period	-45%

Source – www.bseindia.com

Can we reduce the impact of such events?

Yes, we can. While we may not eliminate and predict various events, we can definitely reduce the impact of event risks and other unforeseen circumstances by applying discipline & processes in our investment decisions. While we cannot predict unwanted events with accuracy, we surely can take steps and focus on activities which can reduce the impact considerably.

Mistakes that investors do

It is generally observed that people repeat the mistakes over a period of time. During a meltdown in equity markets, we promise not to over-expose in equity ever again. When organisations fail, we understand the risk of investing in low quality debt instruments and commit ourselves not to make the same mistake again. However, all these learning's go for a toss with time. We make the same old mistakes believing it will not happen again. We chase returns without looking at risk. As long the results are positive, we take the credit ourselves. When it proves fatal, we blame the economy, the government, and if not anything else, we blame our luck.

In the financial world it may not be possible to control returns, but there are tools and mechanism to control risk. Experience and wisdom also teaches this, but we often succumb to the lure and greed for higher returns without looking at the risk.

The perception is greater than reality

Although, recession and other negative events can have devastating impact on client's portfolio, sometimes, perception of this impact is greater than the actual impact. Investor's often make the mistake of looking at individual investments and schemes rather than portfolio returns. Gaining 25% return on "x" investment will give them less satisfaction than losing 20% on another investment, although the overall portfolio might be up by 5%. Generally, investors by default have exposure in real estate, debt schemes, equities, gold etc. Even a 25% erosion on their equity portfolio can create panic as if they have lost everything. Let's examine the following table (Table: 2).

Under both scenarios, it has been assumed that returns in

Table 2: Asset Allocation Scenarios

Asset Class	Assumed Returns in any year	Scenario 1		Scenario 2	
		Asset Allocation	Weighted Portfolio Return	Asset Allocation	Weighted Portfolio Return
Real Estate investments	5%	15%	0.8%	15%	0.8%
Post office / other debt investments	7%	45%	3.2%	30%	2.1%
Equity related investments	-25%	20%	-5.0%	40%	-10.0%
Precious Metals investments, other than jewellery	7%	15%	1.1%	10%	0.7%
Cash in Hand	0%	5%	0.0%	5%	0.0%
Total		**100%**	**0.0%**	**100%**	**-6.5%**

*The above table is hypothetical in nature and is for illustrative purposes only.

a particular year are same, although allocations are different.

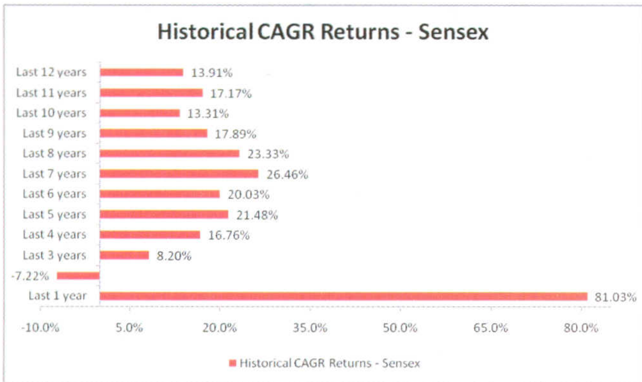
Under scenario 1, due to lower allocation in equity, there is no negative return on the total portfolio basis even though equity instruments gave negative returns.

Under scenario 2, an investor may panic due to a 25% fall in equity portfolio which is a major part of the total portfolio. However, on close monitoring one can see that things are not as bad as it looks when we consider the overall portfolio which is negative by just -6.50%. But as an individual investor, our mind is tuned to look only at losses of a particular asset class and not on the total portfolio.

Periods of crisis in the last decade

There is nothing which didn't happen in the last decade or something which was not welcomed at all. Oil prices reaching an all time high of around $150 a barrel, 9/11 attack, unexpected results in Indian politics, a recession which no living human possibly witnessed before, America's invasion on Iraq, bankruptcy of the biggest corporates in the world, etc. Still Indian equity markets have delivered outstanding performance if one has had the patience of long term investing. (See Chart 1)

Chart 1



Returns as on 31.12.2009.
Source - www.bseindia.com

Suggestive action plan for overcoming the waves of recession:

As they say, prevention is better than cure; investors in consultation with their planners should plan in advance and consider the following. :-

- Identify and write financial goals
- Keeping 6 months expenses as emergency funds in liquid assets.
- Take proper life insurance.
- Take proper medical insurance
- Risk Profiling
- Proper asset allocation in Equities, debt, precious metals and real estate.
- Regular monitoring
- Do not chase returns
- Controlling the greed and fear
- Avoiding the gut feeling

* The above pointers do not form a full financial plan advice. It is only suggestive in nature.

Sometimes, we make things more complicated than they actually are. By following simple processes and discipline one can fight the unforeseen circumstances with more power.

Take Charge

Why not take charge of Financial Planning which will reduce the impact of unwanted situations like recession and other event risks. As discussed, we anyway cannot eliminate event risks from happening. Recessions will come and go. Other event risks will continue to happen. We have no control on them as individuals. But we can certainly reduce the impact of such events by doing a thorough Financial Planning for ourselves and clients. Financial Planning should be done to counter event risks in life so that an individual can handle the situation with greater degree of stability.

Sometimes, we make things more complicated than they actually are. By following simple processes and discipline one can fight the unforeseen circumstances with more power.

It can be said, if you get caught in the rain, you may get wet. But if you have an umbrella with you, you may not get drenched completely. Financial planning can work as an umbrella, should there be rain while you are in the open.

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