Investment Planning During Downturns

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Investing always requires vigilance and self-education, but investment strategies during an economic downturn may require additional adaptation on the investors' part. While investment goals and strategies are highly individualized, certain general strategies can help all the investors to weather tough economic times.

We are all living in a fast and dynamic world, where geographical boundaries have almost become meaningless. Today it seems so correct that 'change' is the only constant in this world and it applies to every aspect of our lives. Small good news can raise the spirits and it's only human to be disappointed on some bad news, the next moment. Investment planning is no different.

During the process of achieving financial goals, there will be lots of ups and downs. Along with periods of optimism, there will be those of disappointments. While the going looks good during good times, it is difficult to cope up with the situation during downturns. All said and done, during downturns confidence levels dip things look bleak and discipline is broken. During these times, very often, we take such actions and commit mistakes, only to find later that they were unwarranted.

While doing investment planning, there are a lot of variables, such as interest rates, inflation rates, expected returns on investment, expected growth in personal income, expected savings rate, and financial goals, which are assumed. Many of these variables can change during the life of an investment plan. Specially, during economic recession and periods of downturns our discipline may be tested. And rightly so, because there may be loss of jobs, loss of income, erosion of portfolio value, etc.

While some situations may demand a complete change in investment planning, in most cases, a review may be sufficient, followed by some adjustments. Let us analyze this further.

Why Do We Invest

Simply put, we invest to make funds available for meeting future needs. Moreover, we target a return on investment which is higher than the decrease due to inflation, so that the purchasing power of money received at a later date is higher than that at the time of investment.

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Greed and Fear

These two factors determine most human behaviors. During good times, we become too greedy and overconfident. During a period of economic contraction, we become too cautious as if everything will come to a grinding halt. The perception of risk during downturns is often bigger than reality and it creates panic. Yes, downturns and period of recession can be pretty long in some cases, but as investors we cannot predict them. However, through regular reviews and minor adjustments, we can overcome the bouts of self-created panic situations.

Long Term Averages

'Average' is a powerful word. When we forecast, we keep the historical numbers in mind. When we assume a particular rate of return for our investments, it has a direct relation to the historical average return. The current economic conditions and circumstances definitely have to be taken into account, but assumptions should be based on long-term historical averages. For example, if the current inflation is zero, we cannot assume inflation to be zero over the next 15 years. We will possibly take inflation at 5-7% which is perhaps closer to the historical long-term average.

Similarly, if equity returns are negative during the past two financial years, we will not stop investing in equities, neither will we plan future equity investments with negative return expectations. In this case also, we will consider the long term historical average of equity returns. Again, for example, the BSE Sensex has given around 13-14% average returns over the past 15-20 years, even though returns are negative for the past 18 months. Yes, volatile markets and negative returns in a shorter period of time impact the investment plan in the short term, but it may not be meaningful in the long term.

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While the long term averages make a strong case for future assumptions, they may not hold true all the time as circumstances change and no one is sure about the future. Had an investor used the long-term historical average as guidance for future equity returns in Japan during the mid-1980s, he would have been in for a surprise. Even after 20 years, Nikkei is trading way below its 1980 peak.

This is where expertise and timing come into play. However, how many of us can predict the future and how many can time the markets? If we cannot, it may make sense to diversify investments, follow asset allocation and regularly review the plan.

Diversification

It is recommended to diversify investments into various asset classes and also within the same asset class. The reason for diversification is based on the fact that one particular investment, no matter how well it has performed historically, may underperform in future. If this were not the case, everybody would invest their entire savings in the asset that has given the best historical returns. The higher the returns, the higher will be the standard deviation of the returns. During the period of economic expansion and soaring stock markets, it seems unwise to invest in fixed income securities. The same is true for equities when the going gets tough. It has been witnessed that most of the time it seems prudent to maintain the asset allocation and ride the volatility without much action.

Cash Flows

One of the serious concerns during downturns is regarding loss of jobs and falling incomes. This has a direct impact on the person's savings and investment plan. This situation calls for a review of anticipated cash flows. Stretching a bit can solve the problem many a time. If the concern is serious, one may have to trim investments in the interim period till things improve.

Reviews

Investment planning is not 'do it and forget it' kind of thing. We plan things based on the current situation, resources, information and assumptions. There are bound to be changes in personal situation, economic conditions and other variables. Reviews, especially during downturns, enable an individual to identify the extent of loss in the portfolio, constraints in the proposed cash outflow towards future investments and reexamination of risk appetite and asset allocation.

Take Professional Help

One must give time to his/her investment planning. A lot of study is needed to remain updated on the investment world. It you think you can manage it on your own, good. Otherwise, take professional help.

Conclusion

Yes, the current global crisis is a tough lesson for all of us. It is time to assess the current situation and start working for a better tomorrow. In many cases, leaving the portfolio as it is may serve the purpose. For many others, it is time to rebalance the allocations on the basis of risk appetite. It is also time to realize that there are no free lunches in this world. Returns come relative to the risks taken. However, taking high risk may not ensure high returns. One should remember this fundamental law of investment. Also, bite what you can chew. If you can manage your cash flows well, do proper asset allocation by identifying your risk appetite and have a long term approach, you are expected to do better than your peers when it comes to investment planning. Happy investing.

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