GIBBS DENLEY
FINANCIAL PLANNING

Financial Planners
Chartered

INVESTING & THE ECONOMIC CYCLE

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INVESTMENTS – A LONG-TERM STRATEGY

When considering a new investment or wondering if you should sell an investment during periods of volatility, it is important to remember that they are a long-term solution. The minimum term we would recommend is usually 5 to 10 years or longer.

We know stock markets are heavily influenced by economic cycles, which are outside of the control of any investor. Periods of volatility and falls in market values are therefore an inevitable feature of investing, rather than something that can be avoided completely.

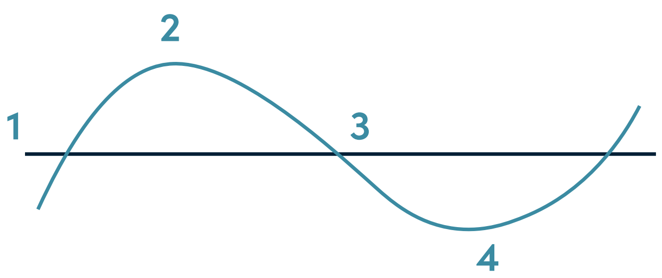
This document will help you understand more about how economic cycles impact stock markets, and how to make informed decisions about your investments, whatever stage you are at in your investment journey.

THE ECONOMIC CYCLE

What is the economic cycle?

The global economy is made of a vastly complex set of moving parts but we can often simplify it to 4 key stages that move between trends of growth and contraction. This is the basis for the economic cycle, which stock markets tend to have a close relationship with.

Diagram of the economic cycle



1. **Expansion –** characterised by generally low but potentially rising interest rates and inflation, rising company earnings and profits, increasing wages, increasing consumption and higher stock prices.
2. **Peak –** usually characterised by rising inflation (as prices have been driven up by wages and spending), interest rates increasing, high corporate profits and higher than average company valuations.
3. **Contraction –** usually accompanied by a recession (though positively managed slowdowns in growth are possible), rates and inflation are near their peak, companies failing to hit their growth targets, falling spending and unemployment rising.
4. **Trough –** Interest rates have fallen in response to poorer growth and inflation is no longer a threat. Higher unemployment, low levels of consumer spending and companies cutting back spending.

No two economic cycles are the same and each has its own nuances, usually dependent on the causes for either growth or downturn, whether that is a housing market crash, geopolitics, war, a crisis in confidence in the financial system or a global pandemic.

How does the economic cycle affect investment markets?

Broadly speaking, stock markets tend to both follow and anticipate the economic cycle, meaning they often react ahead of changes in global economies instead of always following changes.

For example, during periods of growth and economic stability, we will see better performance in stocks as companies achieve higher profits, consumers spend more money, earnings increase and investors have more cash to invest in further growth. During these periods you may see your investments grow.

Equally, during contractions companies will post lower profits and earnings, consumers have less money to spend – or the same money will not spread as far – and investors become wary.

Stock markets may rise or fall in anticipation of either expansion or contraction, as they pre-empt the changes that are coming, particularly anticipated rises or falls in interest rates.

It is important to remember is that it is a cycle, and that after each period of growth, there will be a following period of falls. Not every fund will perform equally, but that is why we build diversified portfolios.

Fig 1. shows the performance of the S&P 500 stock market index, overlaid with US GDP as an indication of global economic change. As US GDP drops, the stock markets tend to experience falls shortly after. Similarly, as economies recover and GDP increases, stock markets tend to enter into periods of positive growth.

Market timing

It's easy to feel calm and confident during periods of growth when you see your portfolio values increase, but we understand it can be worrying during volatile times when you see that your investments have lost significant value. However, making decisions based on those fears can be one of the quickest ways to turn short-term volatility into a concrete loss.

We cannot know in advance how long any period of volatility and market falls will last. However, experience allows us to predict the most likely path and what the key signs of an imminent recovery are. Once those signs start to appear, the move toward renewed growth is likely to be swift. This is why we always advocate retaining your investment at its appropriate long-term risk level: the market will always move quicker than you can invest, meaning you are likely to have realised your losses while missing out on potential gains.

Fig 1. Graph showing the overlap between US stock market performance (S&P 500) and US GDP

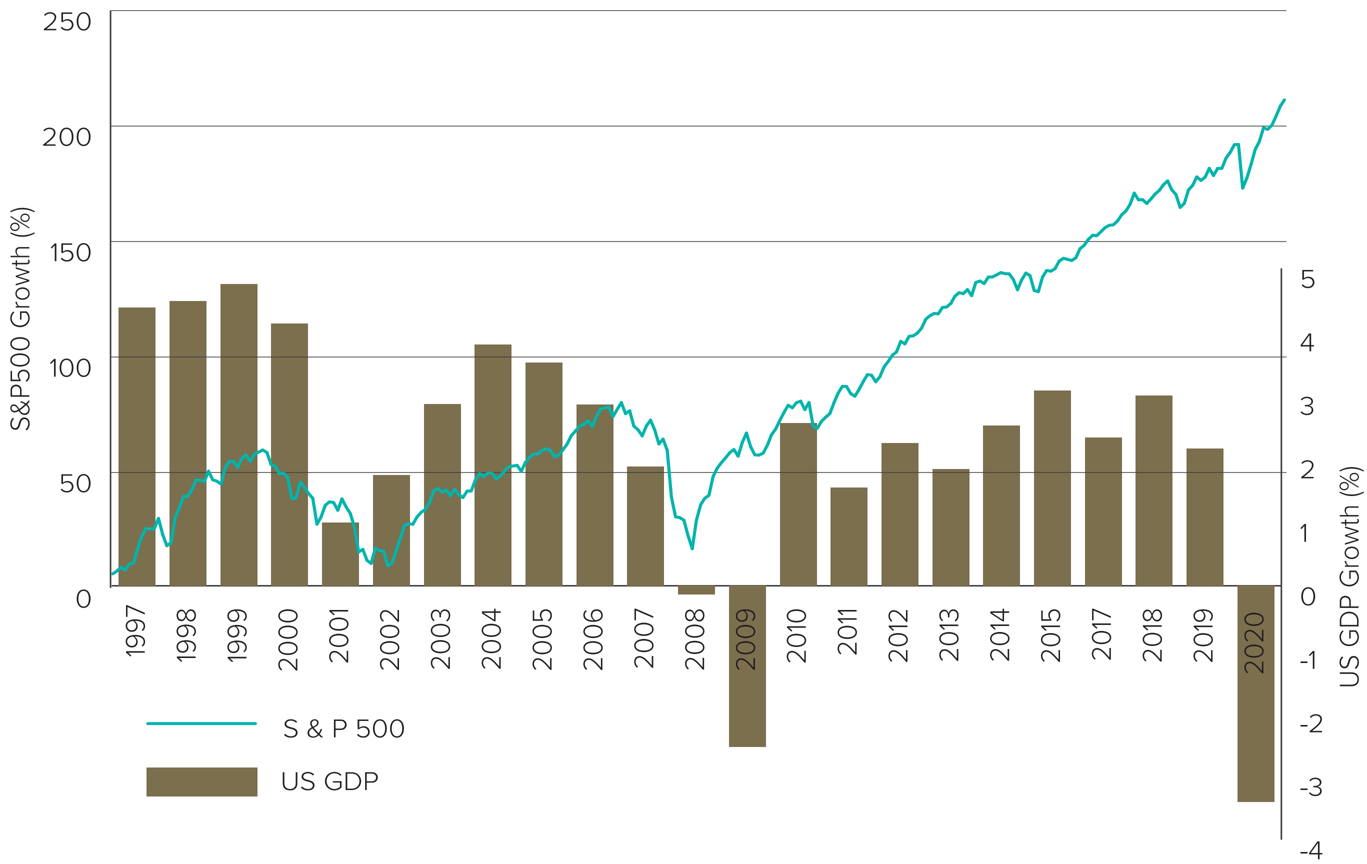


Fig 2. 20 year performance of S&P500 vs S&P500 when 10 key days of investment have been missed

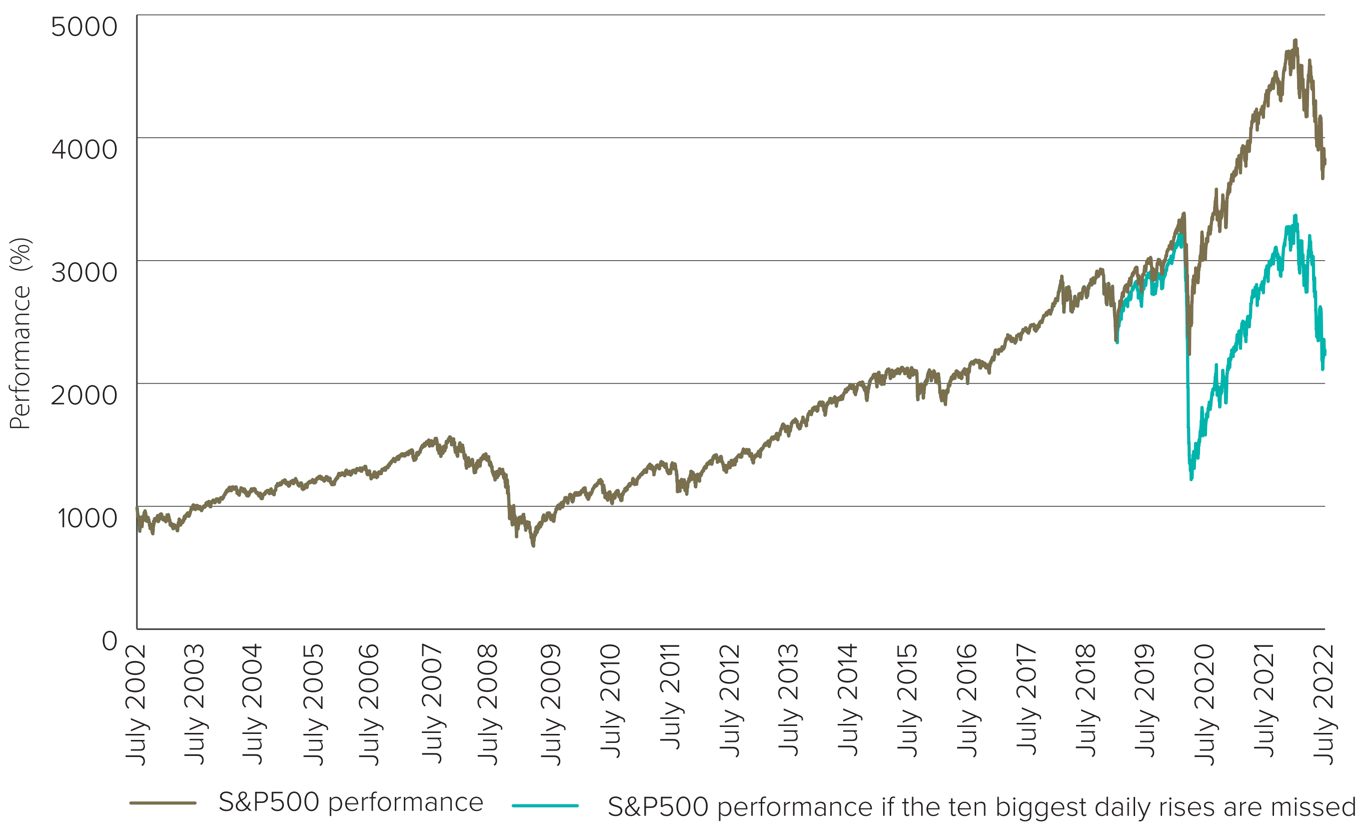


Fig 2. at the bottom of page 3 illustrates the harm that selling your investments during market falls can cause, as it shows the overall performance of the S&P500 against the same performance if you had missed the 10 biggest daily price rises (which came immediately following a fall). Had an investor sold out at this point they would have suffered all of the losses without participating in any of the recovery, making the overall performance significantly lower.

We know that to consistently achieve the best investment outcomes, you should invest for the long term and remain invested through all the ups and downs - a strategy often termed as 'Buy and Hold'. Moving out of investments that have fallen heavily is the most common investment error we see and can be the most damaging to long-term performance because much of the market's greatest returns or declines are concentrated within a few short bursts.

HOW GIBBS DENLEY WORK WITH YOU

Our Investment Philosophy

Our investment team at Gibbs Denley Investment Management (GDIM) always focus on the long term when putting together investment portfolios. Having a suitable time frame is essential to investment growth and while we will try to minimise losses during falls, markets will go against us at times. Working on a time frame of 5 or more years ensures that your investment has time to recover and grow again after any losses.

The portfolios are well diversified so as not to be over-exposed to any single company, sector, country or investment style. We also hold various hedges against risk so that we have a 'cushion' when stock markets fall.

We regularly review our portfolios to ensure they remain within the appropriate risk parameters for their risk tolerance level and are benchmarked against relevant peers.

Market falls are an inherent part of the investment journey, not something that can be completely avoided. We therefore plan carefully to mitigate losses as much as we are able to, and make the most of subsequent opportunities for recovery and growth.

Your Financial Plan

Everyone's situation is different, and your adviser will work with you to put together a financial plan and update it when your circumstances change. Before recommending an investment, and at key stages in your investment journey, your adviser will consider many factors, including your attitude to risk. Importantly for periods of volatility, they will also consider what other investments and cash reserves you hold and how it will impact you if an investment were to fall in value significantly. They know that volatility is unavoidable, and if they don't believe you can withstand any losses, then they will not recommend any investments to you.

Your adviser may also carry out cashflow planning, a useful process that looks at a variety of potential situations that could happen in the future, and how it would likely affect your income and investments in the future. This can give you a realistic idea of what your financial future might look like, even in a worst-case scenario. This can be a source of great reassurance during difficult periods.

As part of our ongoing service, your adviser will continue to consider these factors at each review, and will highlight any need to reduce risk in your investments.

We cannot guarantee that your portfolio will not experience any falls in value. Instead, we aim to work with you to make sure that any investments you make are right for you, and your financial plan can withstand short-term losses in favour of long-term gains.

Return from investments is not guaranteed. Investments can fall as well as rise and you may get back less than the amount originally invested.

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