
# A Brief History of How to Lose Money

by Richard Stutley, CFA

With global equities on track to deliver their best-ever month, against a backdrop of the deepest recession since the Second World War, investors are understandably questioning whether markets have come back too far and too fast. Valuations appear rich in certain areas but trying to time the market is notoriously difficult and can lead to disappointment. At times like this it is worth reflecting on the common ways in which investors suffer permanent impairment of capital as opposed to short term fluctuations in the value of their investments. While the history of finance is long and varied, three factors appear time and again in this regard: counterparty risk, leverage and liquidity. This is a good place for investors to start when appraising risk in their portfolios.

Your counterparty is whoever holds your money, be it an individual, a company, a fund or a country. Given that exposure to a counterparty is a feature of most investments , it only becomes a risk when investors have too much exposure to one counterparty. Things can go wrong for a variety of reasons: while cases of fraud – from Barings Bank, to Enron and more recently Wirecard – receive the most attention, by far and away the most common reason for your counterparty reneging on their obligations is that things simply didn't work out as planned.

The answer to this risk is to be diversified: give money to a number of different counterparties and accept that some won't pay it back. Also evaluate what residual value there is in your investment if things go wrong. If the only residual value is inventory – i.e. there are no durable assets in the business that can be repurposed – then be prepared to get back very little of your original investment should things not work out.

The next two risks – leverage and liquidity – are ultimately about the same thing: being forced out of your investment and into cash at a poor price, commonly referred to as a fire sale.

Asset prices display excess volatility which means they overreact to new information. Often this overreaction sees asset prices fall significantly below fair value. While these instances of mispricing typically resolve themselves in time, meaning investors ultimately only suffered a loss on paper, the danger is that investors are forced to sell at these depressed prices and therefore do not participate in the asset's subsequent recovery.

For example, an investor in the S&P 500 index would have lost 20% of their stake from the start of 2020 if they had been forced to sell at the end of March; that same investor would have instead made 1% if they had been able to hold on to their assets another three months until the middle of July; and 14.5% to Black Friday.

Leverage means debt and debt must be serviced regularly and eventually repaid. These obligations can often only be satisfied by selling assets. Hence leverage may come at a greater cost than simply the interest charge on the borrowing, if it precipitates a fire sale. Given that the golden rule with liquidity is never to need it – i.e. avoid the situation where you have to sell an asset to meet a payment – it is clear why leverage and liquidity go hand-in-hand and need to be carefully monitored.

There are prudent steps investors can take to manage their liquidity. Most importantly, understand how long it takes for transactions involving your asset to complete, and what the average transaction size is: don't expect to be able to sell your asset more quickly or in greater size than the average deal, without offering a discount.

In sum, history shows that appropriate diversification is the first step to protecting one's wealth. Secondly, try and minimise the chances of being forced out of one's assets and into cash, due to excessive leverage or else liquidity needs. Taking note of these lessons from history is not guaranteed to safeguard investors' wealth but it may prevent them from losing money in some of the more common ways.


For more information, please contact your adviser or alternatively contact:

Belvest Investment Services Limited
**研富投資服務有限公司**
9th Floor, Centre Mark II
305-313 Queen's Road Central
Sheung Wan, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
belvest@bis.hk
www.bis.hk

## Important notes