FINANCIAL REVIEW

What to do after a major sharemarket correction

Dedicated share investors have survived major setbacks in the past. Here's how to be ready for the recovery process.

Anton Tagliaferro, of Investors Mutual, warns not to get swept away by any short-term market rebounds. **Louie Douvis**

John Wasiliev
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Shares have given investors a wild ride over the past month. Unless they heeded subtle warnings earlier, many have been left bruised and battered by 30 to 40 per cent reversals in their fortunes.

The warnings were along the lines that the tremendous gains enjoyed by shares during calendar 2019 should not be expected to continue into 2020 and that sharemarkets, which experienced 20 to 35 per cent increases last year, were overdue for a correction.

At the start of 2020 – just three months ago when the bushfire crisis dominated the news and the coronavirus was only just being reported as an internal event in China – the benchmark S&P/ASX 200 index still had another 5 per cent or so to go before peaking just above 7200 in the second-to-last week of February.

No one could have imagined that within a month of peaking the S&P/ASX 200 would fall 40 per cent in an elevator shaft plunge to about 4400, in what veteran share investor Anton Tagliaferro describes as a classic correction.

Corrections, he says, always happen when they are least expected They also tend to happen when share investors are most optimistic. So they tend to catch many people completely by surprise.

Beware dead cats that bounce. **Simon Letch**

Tagliaferro, the founder of the Investors Mutual funds management group, had been expecting a correction for some time. Most people who have been around for a while knew one was inevitable.

But sharemarket corrections, says Tagliaferro, are a fact of life.

In the past 35 years, the Australian market has experienced and survived a steady stream of major corrections, with the most spectacular the 1987 market crash, the 2001 tech wreck and the 2008 global financial crisis. In between there have been many others.

That dedicated share investors have survived these major setbacks – an important point to note – shows it can be done.

So where does this leave investors looking for a sharemarket recovery strategy? Here are five active considerations that will get you going.

Review your strategy

Start by being confident in your existing share investing strategy. This means having a clear plan where the most important considerations are understanding the share investments you own and why you own them. Share investing requires a proactive approach.

Understand the key driver

Know why you are investing in shares. Is it for dividend income or capital gains, or a combination of the two, which the right shares can deliver?

This should always be the number one starting point for any investment strategy, says Tagliaferro. It’s particularly important if you're a planning a recovery strategy.

Why this is so is because there will be days ahead – which may be sooner rather than later, depending on when you commit your money to your strategy – when you will be asking yourself these questions.

Tim Lincoln, chief executive of sharemarket research service Lincoln Indicators, has a strategy that involves investing only in companies his service has identified as quality. Lincoln, who also looks after $600 million in two distinct managed share funds – one that focuses on growth and the other on income – says it is very important to have clear rules when you invest.

A key part of his strategy is taking profits according to rules he has set. On the way up during a rising market, if he gets a 50 per cent gain in any shares in his portfolio, he says, he looks to take that position back to the average weight of the holdings in his portfolio.

What this allows him to do is build up a cash pool that can be used to make new investments, again according to rules he has set himself.

This cash pool is used when the market corrects. Having a strategy that incorporates how to deal with corrections is a better approach than adopting a negative view.

The rules he follows in this instance are that if the market pulls backs by more than 20 per cent, he will move half of his cash into the market but only into investments that meet his criteria.

How earnings might be affected after the health crisis has been foreshadowed as a major issue.

When the market fall exceeds 30 per cent, which hasn't happened very often through history, he will then invest the balance of his cash pool into share investments.

Given the market falls that have occurred over the past month, Lincoln is now fully invested and ready for the recovery he firmly believes will take place – hopefully sooner rather than later. But he accepts it could be as much as a year away

Lincoln believes by choosing quality share investments with sound balance sheets, these will not only rebound first but also have the best prospects of bouncing back strongly.

Make judgment calls

Be aware that any decision to invest during the early stages of a recovery phase will be a judgment call. Tagliaferro says there are many opinions about how shares might perform in the months ahead.

Some say things will get back to normal fairly quickly once the health crisis is over. They are predicting a V-shaped recovery. Others, including him, are more cautious.

When reviewing an existing portfolio, he says, you have to decide whether the business the company operates in will be different once the health crisis is over. This means understanding the business and how it might affected.

If it is likely to be different, this may well be a reason to reconsider its place in your portfolio.

Be risk-aware

Review your response to the latest sharemarket turmoil. How did you react? If it left you uncomfortable, maybe you should be rethinking your future involvement in shares. With any involvement in shares, it is important not to be overexposed as too much exposure is what hurts when markets fall and can lead to panic.

If you're in retirement or nearing retirement, you should have three to five years in cash put aside.

Beware dead cats that bounce

Derived from a Wall Street saying that even a dead cat will bounce if it falls from a great height, share investors must be wary of any sharp recovery that occurs following a severe fall as it could suggest short-term speculators rather than investors are seeing opportunities to trade the market.

Tagliaferro says short-term trading can be hard to pick and he would be cautious about buying and being swept along by any herd mentality when the sharemarket is up strongly. He sees the scope for markets to whipsaw from total pessimism to rays of hope in the months ahead.

Since the fall, sharemarkets have already seen significant daily fluctuations, reflecting the uncertainty. While lower share prices are arguably good news for long-term investors, the immediate problems for buyers are less likely to be price-related but more likely linked to profits and whether dividend shares have the potential to deliver in the foreseeable future.

How earnings might be affected after the health crisis has been foreshadowed as a major issue by about 150 companies that have withdrawn their latest guidance to investment earnings.

So how might investors react to this? Lincoln says when companies withdraw their earnings guidance, this is generally based on concerns their profitability will reduce and lead to a cut in their dividend.

This is something you have to accept as an outcome of the turmoil and monitor where you own shares in those companies, he says. Don't be surprised, he adds, if the world is quite different from what it was before the health crisis.