FORSTRONG
GLOBAL

ASK TYLER

Tyler Mordy,
President & CIO
tmordy@forstrong.com
@TylerMordy

DIVERSIFYING FIRE AND FURY

Should I sell all my stocks, given the North Korean situation?

August 16, 2017

What danger does North Korea present for global investors? Clearly, Trump's indulgence in nuclear brinksmanship carries risk. Pyongyang potentially firing missiles at US territory in the Western Pacific is also real. And there is a global existential threat should it ever escalate into intercontinental warfare.

Yet, rather than add to the volumes of prognostications about North Korea's specific situation, consider the track record of major events and their impact on markets.

First, most geopolitical events are false alarms. As card-carrying members of the change-anticipation field, we understand the desire to divine the big events. To be first to spot the outlines of a looming disaster can be glorious (and career-enhancing).

But most warnings are false alarms simply because big turns are rare events. Remember Y2K, Saddam Hussein's so-called "weapons of mass destruction" and, recently, Brexit? None of these widely-feared threats materialized or they delivered benign outcomes.

Second, more often than not, geopolitical events create opportunity. Rummaging through past post-crisis periods produces a long list of stellar returns after the initial event. For example, the Cuban Missile Crisis in October 1962 was a 13-day confrontation between the US and the Soviet Union, widely considered the closest the Cold War came to full-scale nuclear warfare. However, after the crisis subsided, the Dow went on to gain more than 10% that year. Or take the Korean War, when the North invaded the South. This conflict lasted from June 1950 — July 1953. During that time, the Dow was up an annualized 13.6%. History is brimming with similar examples.

Finally, geopolitical events may have binary outcomes. By this we mean that a negative scenario would either produce an extremely large portfolio loss or gain. There is no knowing which ahead of time. As such, narrowly focusing on one type of risk is speculative at best.

What's more, such speculation hinges upon achieving two near-perfect tactical portfolio actions. One is getting out at the right time; the second is to get back into the markets at the right time. The first decision is difficult at best. The second step is often overlooked. There are plenty of analysts who have predicted doom (most far too early) only to fail to re-invest at the appropriate time. Both errors can be catastrophic.

Consider that investors who went to cash before 2008's global financial crisis looked like heroes for a time. Less widely reported is that a large proportion of them utterly miscalculated their re-entry. Even today, after missing out on a 150% rally in global stocks since early 2009, many of these doomsters remain defensively positioned.

A far better approach is to accept that a wide possible set of scenarios may unfold. From there, investors can insulate against a number of outcomes by diversifying portfolios across global investment classes and also readying them for a change in the macro outlook.

INVESTMENT IMPLICATIONS

Not a small number of people have become financially poor, constantly trying to avoid popularly perceived risks by running for the hills. They fail to realize that if there were no risks for which to be compensated, there would be no returns possible above a bogey risk-free rate. But that doesn't mean that one shouldn't manage risks. To the contrary. What we advise against is a non-diversified definition of risk. Now that "fire and fury" has caught the world's eye (whether based upon real facts or orchestrated histrionics) everyone is focusing on only one form of risk — a "double dare" shouting match between two politicians. Sadly, most investors will continue to suffer for their behavioural weaknesses, while longer-sighted strategists with strong risk management disciplines make off with gains.