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Time to hedge your equity portfolio

Financial markets could suffer 'sudden death'

A guest article by Uwe Günther

Football matches and stock markets have a lot in common: 'sudden death', for example. Investors need to secure their equity portfolios in good times to avoid losing the game out of nowhere.

Twenty years ago the Czech Republic lost the final of the European Championships to Germany, thanks to the golden goal scored by Oliver Bierhoff in extra time. The goal scored by Germany's center forward put an immediate end to the final match of the European Championships. This rule, which has since been dropped in football, originally came from ice hockey, where it is known as 'sudden death'. And this is what threatens the financial markets at the moment: an unexpected event (a goal) in extra time.
To avoid leaving the pitch as the loser, investors should consider the following points:

1. Because every economic and capital market cycle has to come to an end at some point, it makes sense to capitalize the success of your investments in good times – in other words while the upturn is still in progress. In the US stock prices as indicated by the Dow Jones are higher than ever, while the Dax is at least at its highest level for this year. Profit-taking should not be a painful experience here.

2. Of course prices could still continue to rise for some time, but a 'sudden death', an unexpected external shock, could transform this upward trend into the opposite at any time. The risk for investors if this happens is that the gains they have made so far could be reversed, leaving them with a severe negative balance in their portfolio.

3. Both football teams and investors become highly vulnerable if - in the end game (in football) or in the closing phase of the economic cycle (in the stock market) - they go fully on the offense in order to achieve top performance in the last second. They become vulnerable to counter-attacks and their defenses can be overwhelmed.

4. However, the team (the investor) which does everything to prevent a golden goal, fully concentrating on defense and aiming for the penalties for its rescue (salvation provided by the presumed omnipotence of the central banks) is applying a risky strategy – this is sometimes the case in football and always the case for financial markets.

In contrast to football or ice hockey, in the capital markets extra time can often last a punishingly long period. The current period began back in the summer of 2014. Since then the inevitable end of the game has been delayed by the financial drugs administered by the central banks. With their massive bond purchases Mario Draghi and Co. are neutralizing the power of the markets, overriding their natural rules and repeatedly trying to influence analysts, the media and not least investors with verbal and actual interventions.

The central banks are out of their depth

The more the power of monetary policy is reduced, the more the central banks increase the dose. The ECB recently expanded its bond purchasing scheme by €20 billion a month, raising it to €80 billion. At the same time the Bank of Japan has announced that before its next interest-rate meeting on 21st September it will make a comprehensive analysis of its existing stimulus program. However, as inflation is still remote from the target of 2%, further easing measures are to be expected in Japan, too.

When footballers reach a specific level of exhaustion, the additional motivational effect provided by victory bonuses is diminished. Transferred to the financial markets this means that the uncovered financial liabilities which have been created out of nothing are providing the individual economies and stock markets with less and less stimulus. This is the phase the financial markets are currently in – the endgame.

All those who are undisciplined, impatient, greedy and easily influenced run the risk of 'sudden death'. Patient investors, on the other hand, will leave the final percentage points to speculators. By applying some basic rules they can make sure that after the endgame there will no longer be any obstacles to above-average future asset growth.

Best regards,

Uwe Günther

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