Philequity Corner (January 28, 2008)
By Valentino Sy

Turbulence in the markets: calamity or opportunity?

"An optimist sees opportunity in every calamity; a pessimist sees calamity in every opportunity." – Winston Churchill

It has been a chaotic start for global equities this year just as we wrote in our article three weeks back (see "*Volatility and opportunities abound in 2008*" in the January 7, 2008 issue of **The Philippine Star**). Fears of a recession in the US, further write-downs by financial institutions and a weakening corporate earnings picture have caused investors to push the panic button last week.

Tech-heavy Nasdaq has fallen by as much as 23 percent since its peak in October 2007. Technically, this puts the Nasdaq into "bear market" mode – defined as having a decline of at least 20 percent from the peak. Meanwhile, the S&P 500 and the Dow Jones Industrial Average (DJIA) indices have slipped by as much 19.4 percent and 18.1 percent from their peak levels, respectively. Other developed markets were not spared in the sell-off. The Nikkei has dropped by 31.3 percent from its high last year, the CAC 40 has shed 27 percent, the DAX has fallen 21.7 percent and the FTSE 100 has plunged 21 percent from their respective highs.

	Peak 2007	Low Jan-08	% Decline
US			
Nasdaq	2,861.5	2,202.5	-23.0%
S&P 500	1,576.1	1,270.1	-19.4%
DJIA	14,198.1	11,634.8	-18.1%
Average			**-20.2%**
Other Developed Markets			
Japan (Nikkei)	18,300.0	12,572.7	-31.3%
France (CAC)	6,168.2	4,505.1	-27.0%
Germany (DAX)	8,151.6	6,384.4	-21.7%
U.K. (FTSE)	6,754.1	5,338.7	-21.0%
Average			**-25.2%**

Meanwhile, Asian markets (except for Malaysia) also fell in bear market category, after having declined by an average of 23.8 percent. Our own PSEi index has declined by as much as 24.2 percent from its peak of 3,896.7 in October last year.

	Peak 2007	Low Jan-08	% Decline
Asia ex-Japan			
Hong Kong (Hang Seng)	31,958.4	21,709.6	-32.1%
Singapore (STI)	3,906.2	2,746.7	-29.7%
India (BSI)	21,206.8	15,332.4	-27.7%
Taiwan (TWSE)	9,859.7	7,384.6	-25.1%
Philippines (PSEi)	3,896.7	2,953.9	-24.2%
China (Shanghai B)	394.2	304.3	-22.8%
Korea (KOSPI)	2,085.5	1,628.4	-21.9%
Indonesia (JCI)	2,838.5	2,229.8	-21.4%
Thailand (SET)	924.7	730.7	-21.0%
Malaysia (KLSE)	1,524.7	1,340.3	-12.1%
Average			**-23.8%**

Turning point …

Our article last week proved prophetic. We said that the US market "looks extremely oversold" and "a rally maybe just around the corner." True enough, global equities found a bottom last Tuesday when the Fed surprised the market with an inter-meeting 75 basis points cut with a promise of more cuts to follow. On the following day, talks of a bailout plan for bond insurers reinforced the turnaround in the markets. By the end of trading on Wednesday, the DJIA had swung 631.86 points from its low point to its high – the largest single-day turnaround in more than five years.

Or a bear market rally?

Have we indeed found a floor in market prices? Or are we just experiencing a bear market rally? While it is fair to suggest that the markets have been sold off to the extreme and that much bad news is priced in, it is perhaps more prudent to evaluate what downside could remain. To address this question, we observed how previous bear markets in the US played out. Specifically, we examined the extent and the duration of each of the declines.

Note that we subdivided the 2000-2002 bear market into three episodes. The reason for this is that the market was able to go back near its highs. Also, we separated them because of several major world incidents that transpired, i.e. the bursting of the tech bubble, the September 11 terrorist attacks, and the US-Afghanistan & US-Iraq wars.

Bear Market Episodes **Dates**	**Peak**	**Low**	**%Chg**	**No. of months**
Sep 1929 to Jul 1932	386.1	40.6	*-89.5%*	*35*
Mar 1937 to Mar 1938	195.6	97.5	*-50.2%*	*13*
Sep 1939 to Apr 1942	157.8	92.7	*-41.3%*	*32*
May 1946 to Jun 1949	213.4	160.6	*-24.7%*	*38*
Apr 1956 to Oct 1957	524.4	416.2	*-20.6%*	*19*
Nov 1961 to Jun 1962	741.3	524.6	*-29.2%*	*8*
Feb 1966 Oct 1966	1,000.6	735.7	*-26.5%*	*9*
Dec 1968 to May 1970	943.8	627.5	*-33.5%*	*18*
Jan 1973 to Dec 1974	1,067.2	570.0	*-46.6%*	*24*
Sep 1976 to Mar 1978	1,026.3	736.8	*-28.2%*	*19*
Apr 1981 to Aug 1982	1,031.0	770.0	*-25.3%*	*17*
Average (pre-PC era)			*-37.8%*	*21.1*
Aug 1987 to Oct 1987	2,746.7	1,616.2	*-41.2%*	*3*
Jul 1990 to Oct 1990	3,024.3	2,344.3	*-22.5%*	*4*
Jul 1998 to Sep 1998	9,412.6	7,379.7	*-21.6%*	*3*
Jan 2000 to Mar 2001	11,750.3	9,106.5	*-22.5%*	*3*
May 2001 to Sep 2001	11,350.1	8,062.3	*-29.0%*	*5*
Mar 2002 to Oct 2002	10,728.9	7,197.4	*-32.9%*	*8*
Average (PC/internet era)			*-28.3%*	*4.3*
Oct 2007 to Jan 2008	14,198.1	11,634.8	*-18.1%*	*3*

From the table above, we noticed that market volatility has increased in recent years, especially after the widespread use of personal computers in the mid-1980s. Partly due to the computerization & globalization of financial markets, the cycle of decline and recovery accelerated. With instantaneous information from networked PCs, the internet, and television, short-term volatility has increased and long-term swings are much more moderate. In fact, the average duration of the previous six bear market episodes is only 4.3 months and the average decline is 28.3 percent. Prior to PC-era, however, bear markets lasted an average of 21.1 months and declined an average of 37.8 percent.

Meanwhile, the current down cycle is already three months old and the DJIA has lost as much as 18.1 percent already. Therefore, even if the market is just experiencing a bear market rally, chances are the actual bottom may be nearing. Note that equity markets usually move six to 12 months ahead of the economic cycle. Thus, US equities should begin to recover well before the economy has bottomed out and before all the sub-prime losses have been accounted for.

Strategies in volatile times

Bottom or not, the markets are likely to remain choppy through the first half of the year, as investors continue to focus upon the fallout of the sub-prime mortgages and policymakers look for the right solution. It is during these volatile times that one realizes the wisdom of asset allocation and diversification. Ten months ago, in this column, we discussed how the old adage of "not putting all your eggs in one basket" applies to investments (see "*Investment Basics: Asset Allocation*" in the March 12, 2007 issue of **The Philippine Star**). This is a long-term approach to investing. While some assets may fall, others may gain so that over the long term one's portfolio actually carries less risk of volatility and losses.

Another strategy if one has a long-term investment time frame is dollar-cost averaging. This means buying on a staggered basis (usually at fixed intervals regardless of the share price) to reduce the risk associated with making a single large purchase. Dollar-cost averaging is most effective during volatile and falling markets because trying to catch the bottom is foolhardy. History and price charts have taught us this valuable lesson. Whether a bear market ensues or a recession comes in, the markets recover in due time.

Meanwhile, if one has a higher level of risk tolerance and shorter investment time frame, this kind of market environment provides a lot of trading opportunities. In hindsight, last week's calamity was a terrific buying opportunity, especially for the well-informed, nimble and opportunistic.

Clearly, financial markets are driven to a large degree by human emotions. As such, there is no such thing as a rationally-priced stock or a rationally-priced stock market. There are always these extremes, both on the upside and on the downside. And if one can eliminate emotion from the decision making process, either thru diversification, dollar-cost averaging or being nimble, it will translate directly into one's ability to be successful as an investor.

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