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A Practical Approach for Managing Event Risk

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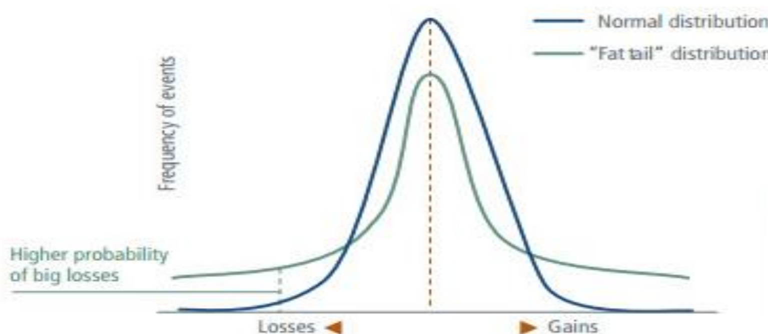
Very few conversations about investing nowadays are complete without some discussion around event risk. Event risk has always been a concern for investors, but really seems to have moved to the forefront of nearly everyone's thinking since the financial crisis of 2008. The most recent possible crisis to hit the markets is the nuclear threat from North Korea. Regardless of whether the threat from North Korea continues to escalate to the point where it will have a significant impact on the markets, I think it gives us an opportunity to take a deeper look at event risk and its impact on the markets and investor psyche.

Unfortunately, there is no tried and true formula for predicting event risk. This is why so much time and effort is spent trying to determine what may cause the next big crisis event. The purpose of this short article is to provide some insight into how Trustmark Investment Advisors, Inc. can help you eliminate a lot of the noise that exists and look at how past crisis events have actually impacted the economy and the markets overall.

What Are "Tails" and Why They May Be "Fatter" than Expected

Investment research frequently refers to tail risk for investors, but it is not always clear what the term means and what you should do about it. The term "tails" refers to the end portions of distribution curves. In investing, the distribution, or bell curve, plots the likelihood of achieving different investment returns over a specific period of time. In a normal bell curve, the most likely outcomes are concentrated around the center of the curve. This represents the mean or average expected return. The tails on the far left and right represent the least likely scenarios, with the lowest returns on the left and the highest returns on the right.



Source: Financial Times

For the average investor, it is the left tail risk that causes the most heartburn when it comes to achieving their financial objectives. However, tail risks, in general, are events with a small probability of happening, and by definition are small, if not tiny. So why is it that we spend so much time thinking about them if they are not likely to occur?

The Dreaded Black Swan

Another byproduct of the 2008 financial crisis was the popularization of the term "Black Swan." Black Swan is used to describe an event or occurrence that is difficult to predict and has a large, outsized impact on the market. Whether it be the media, increased access to information or members of the investment community themselves, the constant coverage and reporting on the next "big" crisis event seems to have been overdone since the Great Recession. It is this increase in coverage that has led people to place too much emphasis on when the next market changing event will occur.

Although we do have events occurring every day around the world that have the potential to impact the markets in a negative way, most of these events do not have the potential to fall into the category of a Black Swan. Event risk can come from events that we know are taking place, such as elections or the Federal Reserve's FOMC meetings. A prime example of a known event risk scenario was the U.S. presidential election in 2016. Another cause of event risk can result from data releases. Economic data revolving around employment, housing, inflation, and a multitude of other factors are released on a monthly basis and have the potential to move markets. For the most part, we as investment advisors, through research and available data, can make educated assumptions as to how most of these events will turn out ahead of time. You have probably heard the phrase "already priced into the market" used quite frequently when listening to discussions about the stock market. Even though we are able to plan for most types of event risk, from time to time we do have events that we do not see coming that result in a surprise and have the potential to cause a significant market reaction.

Surprise Events and Their Impact on Economic Growth

While common sense would tell you that these surprise events have the potential to impact economic growth and market returns, you might be surprised by what you find if you dig a little deeper. A recent research piece by Ned Davis Research identified a list of global crisis events, varying in nature from political, financial, terrorist, or war related, and studied the market's reaction. Ned Davis Research went back to 1960 and found there have been 40 such events. Looking at the results in the chart below, you can see that economic growth did show signs of slowing up to 12 months later. But, if you exclude events that occurred during a recession, the negative impact on growth was very small. The table also shows stock market performance was unfazed up to 12 months later as well, with a median return of 15.49%.

U.S. ECONOMIC AND STOCK MARKET PERFORMANCE FOLLOWING CRISIS EVENTS (1960 - 2017)				
	--- Coincident Index % Gain After ---			
	1M	3M	6M	12M
Median (Crisis Events)	0.10	0.22	0.71	1.32
Median (Crises ex-Recessions)	0.20	0.50	1.10	2.36
Median (Full History)	0.20	0.64	1.28	2.49
	--- S&P 500 Index % Gain After ---			
	1M	3M	6M	12M
Median (Crisis Events)	1.74	1.54	5.96	15.49
Median (Crises ex-Recessions)	1.81	2.71	5.32	15.37
Median (Full History)	0.91	2.30	4.52	9.70
Source: The Conference Board, S&P Dow Jones Indices, Ned Davis Research				
Ned Davis Research, Inc.				*BEC_O201708151.1*

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Managing Event Risk

If you cannot see it or quantify it, how do you protect against event risk in your investment portfolio? Unfortunately, there is no one right way to manage event risk. One of the most important things that Trustmark does for our clients is to set up a proper asset allocation model based on each individual's personal goals and objectives. Having an asset allocation policy with proper diversification and sticking with it through all market cycles will eliminate much of the noise that may cause mistakes in your decision making process. Not sticking with your allocation model is the easiest way to lose money over time. J.P. Morgan recently conducted a study looking at the past 20 year annualized returns by asset class and found that a 60/40 portfolio (60% invested in S&P 500, 40% invested in high quality U.S. fixed income) returned an average of 6.9%, while the average investor returned only 2.3%. The average investor's tendency to react to changes in the market, in many cases as a result of crisis events, can cause them to deviate from their allocation model and impact their returns negatively.

In summation, the likelihood of North Korea becoming the next crisis event is unknown. However, past data indicates that even if this situation continues to escalate, its impact on the long-term health of the economy and the stock market will be short lived. I think the most important thing for anyone when it comes to avoiding the mistakes brought on by event risk is to sit down with their advisors and implement the policies discussed above. Proper asset allocation and diversification will take care of most of the heavy lifting when it comes to reducing event risk in your portfolio.

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