



THE FEROCITY WITH which stock markets have charged ahead to new highs in recent months has surprised many market watchers and led some commentators to warn that investors may be ignoring some dangers looming in the horizon.

On the economic front, the U.S. economy, which remains the main engine of global growth, has been surprisingly resilient to the housing downturn - aided by the healthy job market and rising wages. Inflation fears have also receded as recent data out of the U.S. showed that inflationary pressures are well contained.

On the corporate front, analysts are sanguine about earnings prospects and some have upgraded their earnings forecasts after a generally better-than-expected fourth quarter earnings season, both in the U.S. and elsewhere.

Given this positive backdrop, it's easy for investors to throw caution to the wind and invest aggressively into stock markets, chasing the hot themes like emerging market equities, which have yielded exceptional returns.

Don't Get Carried Away - Stay Diversified

Surveys among portfolio managers show that the "smart money" remains bullish on equities, especially emerging market equities. But it will be foolhardy for investors to ignore risks completely and along with it, the principles of diversification.

In fact, a recent poll commissioned by fund manager, Fidelity Investments (Singapore) Limited, found that diversification appears to be a low priority among Singaporeans investors, with many of them showing little interest in spreading their investments across asset classes and markets.

No doubt, investors tend to ignore the importance of diversification when the bulls are out in full force.

Nevertheless, diversification has its benefits because it helps investors to protect their downside and ensures that they do not over-concentrate their investments in certain areas, even if these are current market favourites.

Take for example the technology sector in the late 1990s. Many investors over-invested in the sector at that time because tech stocks were enjoying run-away prices, even though in many instances, the sharp gains were not backed by solid fundamentals. So when the tech bubble

Stay true to the principles of diversification and don't ignore the dangers signs despite strong activity in the stock markets.

By Vasu Menon

Don't Ignore the **Danger** Signs

burst in 2000, many investors suffered hefty losses and became disillusioned. Some are still nursing their wounds.

As an aside, how an investor chooses to diversify his investment portfolio depends on a number of factors including his age, the life-stage he is at (eg. whether he is single, married, married with children, etc.) and his appetite for risk.

So for instance, a young single adult with a high risk appetite may wish to invest most of his portfolio into equities, while keeping his bond holdings minimal. In this instance, such an individual may choose to invest as much as 80 per cent of his portfolio into equities and 20 per cent into bonds.

Although most fund managers favour equities over bonds at this juncture, investors should still have some bonds in their portfolios, as bonds provide a good hedge against the risk of a weaker-than-expected economic slowdown. Also bonds are generally much less volatile than equities, and so they bring stability to an investors' portfolio.

Some dangers to bear in mind

Back now to what we discussed at the onset i.e. the market ostriches ignoring danger signs.

The risk of a sharp pullback in equity markets cannot be discounted and there are good reasons to be cautious.

Remember the sharp sell-off in equity markets, especially in emerging markets, in the second quarter of last year? That was triggered by a significant withdrawal of liquidity as the yields on U.S. Treasuries rose and after speculative carry trades were unwound on the back of a sharp appreciation in the Yen.

Could the same happen again this year? It certainly could, and investors should not be oblivious to this danger.

For one, U.S. Treasury yields have been inching up as markets are concerned that the U.S. economy's unexpected strength may rekindle inflation and prevent the Fed from cutting its benchmark interest rate until much later

this year. Optimism about rate cuts in the U.S. was one reason for the strong showing on Wall Street and other global equity markets in the last few months. If investors backtrack on these expectations in a big way, it could affect liquidity flows and cause markets to correct sharply.

Carry trades have also contributed to a surge of liquidity into equity markets. The Bank of Japan's reluctance to increase near-zero interest rates in the country, coupled with the weak Yen have helped to supply liquidity to the global financial system. Estimated to be in excess of 40 trillion Yen, these carry trades are sizeable and can inflict significant damage to markets if they are unwound – as they did last May.

But what could trigger this? Perhaps it could happen if the Bank of Japan finally shows conviction and goes against political pressure to raise interest rates from rock-bottom levels. Alternatively, if the Yen rebounds sharply from its lows, speculators who had borrowed the currency heavily will get hurt; should they turn jittery and unwind their heavily leveraged positions, a sell-off could ensue.

No doubt, the withdrawal of liquidity poses one danger and investors should not ignore it.

However if there is a sharp pullback, this could also present an opportunity to get into equity markets given that the medium-term investment outlook remains sanguine. But for average investors who may not be comfortable with timing markets, they may want to spread their investments over a period of time, perhaps through a regular investment plan. This allows investors to continue participating if markets pullback.

Conclusion

While the investment outlook remains positive for the medium-term, there is a risk that equity markets, which have done exceptionally well in recent months, could pullback in the short-term if some of the dangers lurking in the immediate horizon materialise.

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So despite the current exuberance, investors should not get carried away and jump aggressively into hot themes, hoping for quick and exceptional gains. Instead, they should keep a level head and continue to maintain a diversified portfolio - possibly even spreading out fresh purchases over time through a regular investment plan. 

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