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Demystifying Black Swan – events & ideas

Dear Investors,

A few years ago, I had made a family trip to the Chinese town of Chengdu, where in the middle of the white panda spotting, we saw a lake full of strange looking birds – the Swans, however, not the ordinary but the jet-black ones. This bird which is usually white in colour, attracted the attention and curiosity of many onlookers and selfie takers.

For those who are financial-nerds, or ones who follow Mr. Nassem Taleb, may know why – the black swan is a creature that was hypothesized not to exist, until it was discovered few years later in Australia. In finance, we refer to Black Swan events as big, disruptive events that are completely unpredictable, and shake the world around us – Wars, radical technological disruption, market crashes, to name a few.

We're not even three months into the decade, and it feels as if we're living in a pond full of Black Swans – the COVID19, the turmoil in Yes Bank, and a 30% single day drop in Oil Prices. Incidentally enough, COVID19, has its origins in China!

Black Swans events are tough for investors to digest since we believe that the world is knowledgeable, risk can be measured, and the future can be forecasted to some extent. Realms of press and interviews are devoted in predicting what the markets will do, where bond yields will go, which stocks will emerge victorious, and BANG! The COVID19, which most of us are oblivious to, let alone forecast, comes along.

Interestingly, Mr Taleb says, Black Swans can be rationalized well in hindsight, the "this was so obvious" moment. Social media instantly emerges with experts who can talk about bank collapses and suddenly books are appearing that had already claimed predicting COVID19 coming in 2020 (and reappearing in 2030 after a mysterious disappearance).

But Black Swan events have always been random.The failure of LTCM for instance, was not predicted by any computer model, but was driven by the Russian government's debt default.Who could've predicted the atomic bomb on Hiroshima in 1945, the September 11 attacks, the destruction of Pompei in 79 AD, the implosion of Enron, or the 1929 stock market crash? The tricky aspect of Black Swans is while their impact on financial markets is sharp and negative, it is hard to predict how long they will last and how fast the recovery will be. But do notice India's reaction to 3 Black Swans historically, viz. The dot com crash of 2000 caused a -48% crash in markets and took nearly 27 months to recover. In contrast, 9/11, a major global event led to a -16% fall but recovered in less than a month. 2008's GFC saw an even bigger cut of -58% versus 2000 but recovered in 20 months.

Black Swan events, like my China sighting, are also becoming more frequent lately. And since we know we cannot predict, the best thing we can do is prepare our portfolios against them. Using intuition, common sense and good investment principles, one can make portfolios – crisis and Black Swan proof as much as possible. Here are five Black Swan tips, that I learnt, during my first Black Swan event in 2008.

1. Cash is your friend. Keep some cash in your portfolio that can be used, or if not required, invested to take advantage of the crises. Low risk equity funds like balanced advantage funds are also a way to achieve this.

2. Diversify currency risk. The Indian rupee and emerging market currencies are vulnerable in Black Swans. Assets like gold and international equities provide a hedge against the sharp currency depreciation that happens at these times.

3. Illiquidity is costly! This implies liquid assets becomes less liquid, and illiquid assets become extremely illiquid in a crisis. Always keep a watch on the liquid assets you have and the liquidity of the underlying funds.

4. Leverage should be limited. As we all know leverage feature amplifies the good and the bad times both, and not everyone can handle leverage. In a Black Swan, when NAV see 50% cuts, leverage leads to margin calls, and forced selling which is sub-optimal. Limit leverage, especially where the underlying is risk.

5. What is too good to be true, isn't true. Every bull market will create few instruments that looks like the perfect arbitrage, for example the structured bond through one tweak that makes it yield 1% more attractive than an equivalent normal bond. In a crisis, the said tweak will unwind. Keep a watch for these not so cute instruments in your portfolio, that carry structural risk.

Finally, on the day of a Black Swan event, or a large market crash, like the one we saw last Friday, can lead to extreme sentiments, triggered by reading the news, watching social media, or by just a lack of control on the unknown. A senior fund manager once told me, on the 'D' day, the worst thing you can do is redeem and run away from the markets, the best thing you can do is perhaps have the courage to invest opportunistically, and the minimum you can do, is to just stay calm and do nothing.

Happy and peaceful investing.

Regards,
Radhika