Oakwood
FINANCIAL ADVISORS

Client Note – Ukraine, Financial Markets & Inflation

A lot has unfolded across the Russia-Ukraine border in the last month. While much of the information reaching us is no doubt clouded by the fog of war, it is shocking that so much destruction and suffering is being experienced by so many. While the note below touches on the possible financial ramifications of current events, we are not uncaring of the terrible loss and destruction felt by so many who are caught up in the violence.

A Time for Prudence

The unfolding situation in Ukraine is deeply worrying, like countless other events in our history. However, knee-jerk reaction to global events with investment policy is a dangerous pursuit. It is natural to be fearful during such an uncertain time. However, acting on this fear is entirely problematic, a misstep now can usually result in disastrous financial outcomes. Many investors struggle to recover from these outcomes.

Minimal Changes is the Order of the Day

As an experienced investor I plan to make minimal changes to my pensions and my family's investment portfolio. And I urge my clients to proceed in the same manner. If you have a well-constructed long-term plan, no impulsive reaction is needed. Even if you believe that current events will negatively impact the world economy, it is not obvious how markets will react. In the long term, the economy and the market move in unison. In the short term, there is no correlation. The market reaction to the Covid pandemic proved this again beyond doubt.

Markets are Cyclical

Successful investing is about avoiding mistakes and being calm through all market cycles. Why sell something you think has a positive long-term future to prepare for a dip you expect to be temporary? This advice is incredibly simple but unfortunately incredibly hard for most people to follow.

Moving to Cash has Risks

I understand that the temptation during a time like this is to move your money into a "safe" asset like cash. However, this decision forces you to make two correct timing decisions.

a) The first is when to come out of the market
b) The second is when to get back in

Thinking that you can consistently get these two decisions right ignores everything we have learnt from history.

Take a Longer Term Perspective

When you invest in a global equity portfolio, you own a collection of companies that we use every single day. Real companies, full of highly professional people operating in their area of expertise, where you profit from their collective ingenuity. These companies will capture their fair share of profits and innovation in the decades to come. If you have an investment time frame of 5 to 10 years, making investment decisions based on the last 30 minutes or 30 days of current news is a recipe for disaster.

Stock Market Movement Recovers from Temporary Adversity

The admission price to long term wealth through stock marketing investing is possessing the courage to do nothing when your natural instincts are telling you to run. No one knows where the market is heading. A few people will make predictions that may turn out to be correct, but it is impossible to know with foresight who they are and whether it was luck or judgment.

There will be many more market declines over the course of your lifetime. These will be temporary declines. Behave correctly and the permanent returns are yours. The stock market has proven that it advances after all shocking world events. I'm not changing my long-term investment portfolio, and neither should you.

> ***"A permanent loss in a well-diversified equity portfolio is a human achievement of which the market itself remains incapable."***
>
> — Nick Murray (US Financial Guru)

Current Markets & Inflation

The fall in equity markets so far in 2022 had substantially been incurred before the events in Ukraine with **inflation the main concern for markets.**

The table below provides a summary of returns Year-to-Date to the 25th March for several major equity, bond, commodity and currency markets/indices.

2022 Year to Date (25th March)	
World Stock Markets	**Gain/Loss**
FTSE World Index (€)	**-2.9%**
FTSE World Index (€) (x-US)	**-6.4%**
S&P 500 Index (€) (US)	**-5.2%**
FTSE Asia Pacific Index (€)	**-5.98%**
FTSE Emerging Markets Index (€)	**-6.01%**
Euro Stoxx 50 Index (€)	**-10.02%**
ISEQ (Irish Stock Exchange)	**-14.30%**
Gold Price (€) *	**6.9%**
Silver	**10.6%**
Brent Oil	**54.5%**
Commodities Index (€)	**33.40%**
Dollar Trade Weighted Index	**6.40%**
Sterling Trade Weighted Index	**5.20%**
€ / £ Exchange Rate	**-1.2%**
€ / $ Exchange Rate	**-3.50%**
US 10-Year Bond Yield	**1.51%**
German 10-Year Bond Yield	**-0.18%**

* Gold is priced in US Dollars and when converted resulted in a -3.6% real return.

Inflation is the greatest threat to your savings

The Economic and Social Research Institute (ESRI) this week warned that the Russian invasion of Ukraine may usher in 1980s-style inflation in Ireland. While inflation, due to the surge in energy prices, is expected to peak at about 8.5%, the projection for 2022 is around 6.5%.

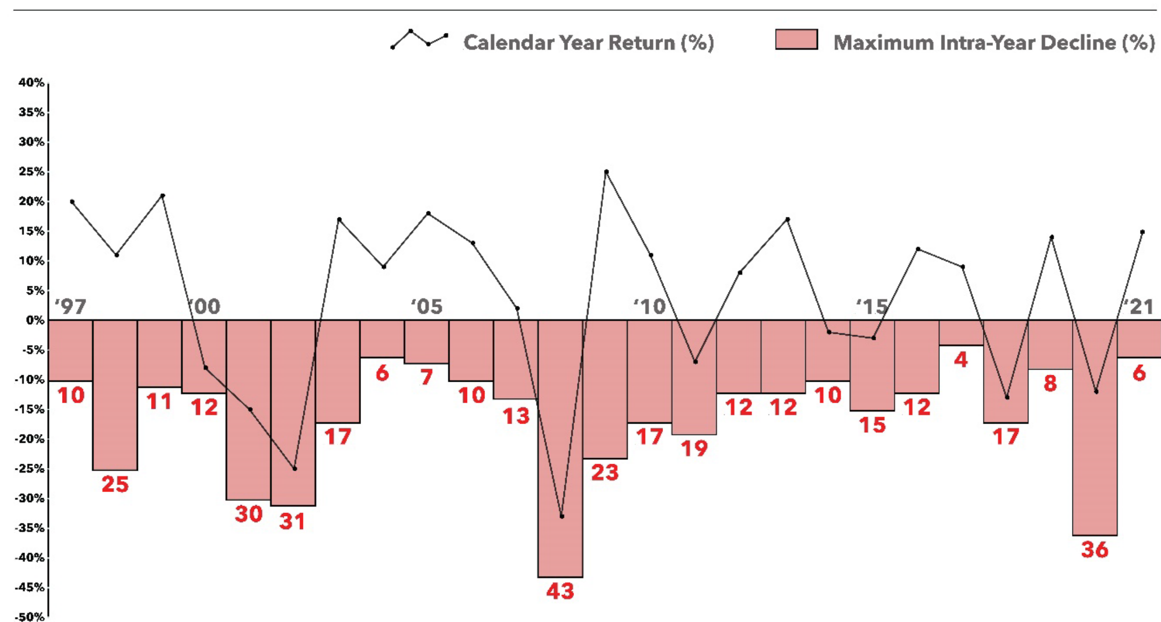
Stocks and sectors which had been market darlings have suffered heavy falls year to date. The *Information Technology* sector was hardest hit, dropping close to **20%** with one of the flagship names, **Meta/Facebook**, falling by over **50%**. More generally, the market saw a marked rotation towards Value stocks with the *MSCI World* index outperforming the Growth variant by **10%.**

The risk of short-term capital loss preoccupies decision making. Corrections of over 10% occur in most years. But that's not the relevant measure of risk. Investing in the stock market has always involved short term losses – the US market declines on average almost 15% each calendar year, and sometimes twice that.

What should concern you is the real, after inflation, value of your funds. With inflation as your risk metric, equities, property and real assets become low risk given the protection they have provided against it. You should invest up to your comfort level and try to consider risk as something other than short term loss or volatility.

Annual Declines

Market corrections come around as often as your birthday



Source: Koyfin, Humans Under Management.
Returns are based on the FTSE All Share price index from 1997, excluding dividends. For illustrative purposes only.

In the chart above we outline the positive returns (black figures) versus the declines (red figures) each year. At one point in 2021 the FTSE All Share index was down 6% and finished the year up 27%. In 2010 the index was down 17% at one point and finished the year with a positive 12% return. Likewise in 2005 the index had a low of 7% during the year and finished it out with a positive return of 18%.

Inflation Protecting Assets

To beat inflation, you need to invest in growth assets – quality individual equities, equity funds, property (direct or through funds), infrastructure funds and inflation linked bonds. Gold and commodities can also offer protection as a hedge against both inflation and an escalation in the current war in Ukraine.

Equities Survive Inflation

Equities over the long term have provided strong real returns (after inflation). If your metric for how much risk you take on is maintaining purchasing power, then the stock market (alongside property and other real assets) has proven to be an important generator (and protector of) real wealth.

Here's how Stock Markets provide a Hedge against Inflation

The data suggest that stocks, in general, do well when inflation is between 1% and 4% (based on US equity style/cap indexes). Many companies have pricing power, i.e. can pass along costs to buyers in the form of higher prices and thereby protect their margins. Not all companies do, however. So, inflationary regimes may favour some market segments more than others. But in aggregate, stock markets have historically provided strong after-inflation returns, at least part of which stems from company earnings being linked to inflation through pricing power.

If you have a well-planned Portfolio, Do Nothing

As we see it, people who are already invested at the risk level appropriate for them, with a suitably long time horizon and who can meet their objectives with realistic return expectations, have no reason to do anything.

Inflation should be your Main Concern

The impulse to protect what we have is a natural instinct to us all. Aversion to risk is built into us humans and we are predisposed to overweight the negative. Even when presented with a favourable proposition, the majority of us will generally avoid it if there is the potential for significant downside.

Inflation – The Silent Erosion of Value

We tend not to think about inflation risk in the same way as we do about the risk of capital loss associated with stock market volatility. Inflation is a silent erosion of value. If your living costs increase and your capital and interest thereon remain the same, you have effectively lost money.

Every €100 you had in cash, is worth €95!

If we look at 2021, inflation was over 5%. On that basis, each €100 you had in the bank in January 2021 was worth €95 by December 31st. The projected inflation rate for 2022 is 6.5%. This should trigger alarm bells for the risk-averse, but usually it doesn't.

Cost to Investing - Volatility

There is a cost to investing. This is represented by volatility - short term market declines - as outlined in the chart on page 4. The possible decline is the cost you may have, but there can be a greater cost if you do not invest. The short-term pain of loss is offset by the potential for **meaningful long-term returns**. Psychologically, this can be easier to accept in theory, than to follow in practice.

The Market Moves Down - And Then Recovers

We know that stock markets provide positive returns, usually about three in every four years. The negative year is the fee that earns you the other three positive years. It's the price of admission for profiting from the collective ingenuity of the hundreds of companies within the funds in which you have invested. They are working for you while you sleep. You should recognise the temporary declines as the reason for the stock market's permanent long term positive returns. You can't have one without the other.

Achieving a Balance - Between Short- and Long-Term Considerations

As I have previously advised, when investing it is about finding a balance in your portfolio between growth assets (equities and property) and defensive assets (cash/deposits & bonds). It is about calculating your short-term needs (cash) in line with the risk of longer-term investments.

Move Surplus Cash into Growth Assets

The risk is maintaining the status quo. The decisions you don't make. That is deciding to leave your excess funds in cash. This is a flawed decision. It has the potential for a greater loss of your wealth, over time, than that experienced in the stock market.

As always, I welcome your comments, questions and concerns.

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