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Spotlight On Risk And Natural Disasters

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Does our perception of financial risk stay constant or change over time? To examine this, let's review how investors viewed Japan after the earthquake, tsunami and nuclear meltdown. Japan's triple disaster happened suddenly and response to it was almost as swift. The key Nikkei 225 equity index fell 20 per cent in the week after the March 11th events. Some claim this was an irrational response due to the emotional shock while others say it was a rational response to a shift in risk.

What we know from history is that whenever a major natural disaster occurs, demand for liquidity (cash) soars in the affected region.

After the tsunami, Japanese authorities decided to keep their capital markets open. This meant investors could sell assets to raise cash if they so wished. However, a mass exodus from long-term securities in favour of immediate liquidity, if left unchecked, could have far-reaching negative consequences.

No Surprise

So it came as no surprise that the Bank of Japan intervened to ensure the banking system remained solvent and liquid. This move helped calm average Japanese citizens.

And how did global investor's react? As the crisis unfolded, analysts and media reports stated that Japanese GDP would decline significantly in the coming quarters or years. This predicament was made worse because Japan is known for its ineffective governments. As uncertainty rose, so too did the discount rate for evaluating investments.

Essentially, investors demanded a higher return as compensation for the higher perceived risk they now faced. Without additional compensation, nervous money would shift towards relatively safe assets such as U.S. Treasury bonds, gold, commodities or Canadian dollars. This is exactly what transpired – Japanese equity prices dropped while a host of 'safe' assets increased.

The Japanese earthquake reaffirmed several important investment concepts. First, natural disasters are impossible to predict or time. In general, this also applies to financial markets. You can't make money on events that haven't occurred yet ... unless you're psychic.

Second, once a disaster does occur, investors scramble to own 'safer' assets. This happens during natural and financial disasters.

Can you recall the 2008 Credit Crisis? An examination of the data shows a similar pattern, although that crisis lasted much longer. During that period, the problem was seen as global and the outcome very much in doubt. With Japan's crisis, all the problems were contained regionally (nuclear issues aside). As well, the outcome seems more certain (a mass rebuilding effort will likely soon commence).

Third, after a disaster, certain investors want liquidity. Who are they? They might be speculators who typically have a very short-term investment horizon, or long-term investors who view the transformative events as a permanent change to the investing landscape. It might be investors who have reached a certain age and can't tolerate volatility, but haven't yet shifted assets to a proper mix. It could also be performance sensitive money managers who would rather avoid holding assets in a country with too many unknowns. This is known as the 'playing-it-safe' approach.

Re-pricing Of Risk

Fourth, as liquidity needs rise, prices for 'risky' assets fall and prices for 'safer' assets rise. This process, which is essentially a re-pricing of risk, sets the stage for future positive returns from the very assets that have now been abandoned.

What we have not covered thus far is what impact the financial instruments had on this crisis. We know that products developed over the past few decades can either exacerbate or exaggerate the short-term impact of rapid changes to risk. Whether these are derivatives or leveraged exchange-traded funds, global money flows can accelerate wildly through these products.

For investors everywhere, there are two fairly important implications.

The first is that having a crystal clear time horizon is a key to investing success. Without it, investors are prone to reacting to whatever short-term situations arise.

The second implication is that controlling one's emotion is critical. Without this, there's a chance of getting caught up in short-term frenzies. In today's internet society, Japan's disaster unleashed an emotional torrent that was hard to ignore and may ultimately prove financially detrimental.

The perception of financial risk can change quite rapidly. However, real financial risk changes at a far slower pace. This is one concept that even investment professionals have a tough time coping with.

By the way, at the end of March, the Nikkei 225 had jumped 13 per cent above its intra-month lows. Some of this rebound is simply a reversal of the initial panic. The rest comes from a re-evaluation of the country's future. And that future still appears to be relatively intact. ■

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