How to Cash in on the Next Market Crash

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Is it safe to say it's over?

I think so. It's possible the recovery has been too far, too fast. Markets could very easily fall from here. But the economy is already recovering, the health crisis is not as bad as feared and many companies are providing surprisingly positive updates. We aren't going back to the lows of March any time soon.

If so, that was one hell of a market meltdown. The speed, magnitude and violent nature of the selloff dwarfed the financial crisis. Many investors—including professionals—crystalised the losses by panicking at the worst possible time.

One bad decision in a crisis can undo a decade of disciplined investing.

In the ebullient markets of the past few years, we've made more than our fair share of mistakes. But crises are our time to shine. We are naturally wired to buy in times of panic. It comes easily to us. We get excited. And we've executed well over the past few months.

Here are a few pointers if you are one of the many to whom it doesn't come so easily.

1. Next time will always be different

Here is what you will be saying in the midst of the next market meltdown. I know Steve said next time is always different. But I swear to God, this really is different.

And yes, it will be. Because whatever causes the next crisis will be something we haven't seen before. This is not a feature of a market meltdown, it is a prerequisite. We don't panic about things we have seen before, because they always worked out ok (we're here, aren't we).

We panic about events we haven't seen before because we don't know what's going to happen. That's not to say things aren't going to be different. They might well be. It's just not a reason to panic in the heat of the moment. You know now, in advance, that the next crisis is going to be different. So don't be surprised when it happens.

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2. The clearing price is not the value. Not always, anyway

The stock market is an exchange. It is a place (a virtual place these days) where buyers and sellers meet to exchange their shares in companies on a daily basis. Accountants like to use the last traded price as an estimate of the fair value of a whole company. And often it is. There are lots of potential buyers who don't want to pay more than fair value for their BHP shares. And lots of potential sellers who don't want to receive less than fair value. The clearing price—the price at which they overlap—is often as good a guess as any to the value of what they are trading.

It is important to remember, however, that the price is simply the level at which supply and demand meet. While it often represents a fair reflection of a business's prospects, that doesn't have to be true. Sometimes the sellers simply need cash and will take any price they can get. Sometimes the potential buyers are far more fearful than usual. When desperate selling meets reluctant buying, the clearing price is going to be a lot lower than it would otherwise be.

Keep that in mind next time you see a headline like "Investors lose $50bn in ASX meltdown". Because "investors" didn't really lose anything. A desperate seller sold a parcel of shares to a reluctant buyer (usually a fairly small percentage of the total value of the company or market). And the price was simply the price that worked for both of them on that particular day.

3. The market bottom will have nothing to do with profits, unemployment or the real economy

Many investors are still scratching their heads. Australia is probably in recession. The unemployment rate is going up. The government is racking up huge fiscal deficits. Yet the All Ordinaries Index has risen 37% since its low on 23 March*. What gives?

I'm going to write this in capital letters and bold it. **THE MARKET IS NOT THE ECONOMY**. Write it down. Imprint it on your memory. Put a poster on the wall. Here is how markets bottom.

Think of that market clearing price as having two components. One is the overall expectations about the future. People's estimates of fair value change with their expectations of the future. The lower the expectations about the future, the lower the "fair" clearing price.

But then that "fair" price can be moved, sometimes significantly, by short term flows, as we discussed above. If the fair value is the sum of people's expectations, the actual traded price is attached to that fair value by an elastic band that stretches to accommodate daily flows of money.

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In a market meltdown, these two factors combine. Expectations are already low, and those low expectations meet a crescendo of forced selling that stretches the elastic band. Investors are panicking, super funds are suffering withdrawals and funds are meeting client redemptions by selling the underlying stocks. These flows can cause the clearing price to vary dramatically from even the most pessimistic investors' expectations about the future.

The turning point is when that forced selling starts to peter out. There's still a lot of panic. There are still a lot of redemptions. But it's just a tiny bit less than the day before. This first phase of the recovery is often quite violent. As soon as the selling slows, the clearing price snaps back to something resembling actual expectations.

Those expectations, however, are still low. We're still expecting a horrible recession. We are still expecting a lot of businesses to go bust.

The next phase of the market recovery comes as those expectations start to improve. Note that I am using the word "expectations". The question is not whether we are going to have a recession. The question is whether that recession is going to be as bad as we thought it was going to be yesterday. The day sentiment improves is the day the market moves.

I'm not for a second suggesting picking the bottom is easy. Sentiment can always get worse. Panic can often feed on itself. But at least know what you are looking for. If you are sitting there waiting for the real economy to improve, you are certain to miss the bargains.

One mistake you can't afford to make

So next time there's a meltdown, pull this list out and read it multiple times.

You can get away with not deploying all of your cash and still end up with perfectly acceptable long-term returns. You can be fully invested all the way through a crisis like that and end up doing just fine. You can deploy some cash at or near the bottom and dramatically improve your results. What you can't do, ever, is be fully invested at the top and panic into cash at the bottom.

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