War and Peace (and the Stock Market)

Darrin Erickson, MBA, CFA, Portfolio Manager, Perron Asset Management

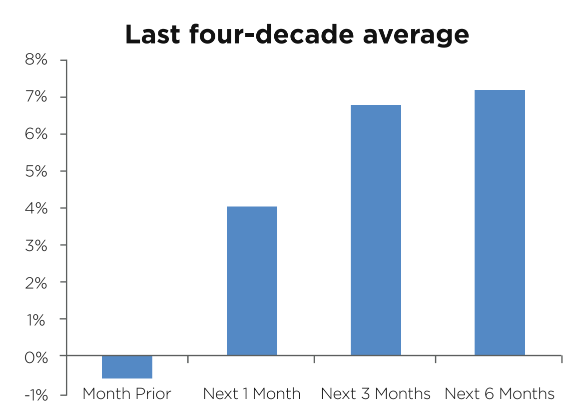
"In nuclear war, all men are cremated equal."

Dexter Gordon

Sabre rattling has once again sent ripples through global financial markets as the prospect of US military action against North Korea looms. Although the North Korean regime has a history of making threats to extract financial concessions from the West, this situation has become especially tense because North Korea has the ability to target US allies and territories with nuclear weapons. To make matters worse, the North Korean regime has openly expressed a willingness to carry out this type of attack. Fortunately, we believe this action is very unlikely given what would undoubtedly be a swift and massive response by the US that would most likely end with the removal of North Korea's political leaders and the destruction of its military capability.

While the odds of a conflict with North Korea remain low, we believe it is prudent to revisit the potential impact that a conventional (non-nuclear) conflict would have on our clients' portfolios.

Investors do not like uncertainty, and so historically markets tend to weaken as tensions increase and the probability of US military action grows. Once the actual conflict begins, the stock market tends to rebound and actually performs quite well over the next couple of quarters.



*Grenada (1983); Panama (1989); First Gulf War (1991); Kosovo (1999); Afghanistan (2001); Second Gulf War (2003); Libya (2011)

Source: www.HulbertRatings.com

War and Peace (and the Stock Market) *Cont'd*

A study published by CFA Institute showed that markets also tend to experience a decrease in volatility after hostilities commence.

This study, shown in the table below, reveals that Large-Cap stocks had an average annual rate of return of 10% from 1926 to 2013, with an average volatility of 19%. For all wars during that same time period, Large-Cap stocks earned an average return of 11.4%, with a standard deviation of only 12.8%. Small-Cap stocks experienced a similar improvement in their risk and return profiles during times of war.

Intuitively, one would assume that fixed income instruments, including long-term bonds, should perform well during wartime, but in fact the opposite is true.

Capital Market Performance During Times of War

	Large-Cap Stocks	Small-Cap Stocks	Long-Term Bonds	Five-Year Notes	Long-Term Credit	Cash	Inflation
1926-2013							
Return	10.0%	11.6%	5.6%	5.3%	5.9%	3.5%	3.0%
Risk	19.0%	27.2%	8.4%	4.4%	7.6%	90.0%	
All Wars							
Return	11.4%	13.8%	2.2%	3.7%	2.8%	3.3%	4.4%
Risk	12.8%	20.1%	6.4%	3.5%	5.5%	0.7%	
World War II							
Return	16.9%	32.8%	3.2%	1.8%	3.0%	0.3%	5.2%
Risk	13.8%	21.0%	1.9%	80.0%	1.1%	0.0%	
Korean War							
Return	18.7%	15.4%	-1.1%	70.0%	0.3%	1.5%	3.8%
Risk	11.1%	12.7%	3.0%	1.7%	3.2%	0.1%	
Vietnam War							
Return	6.4%	7.3%	1.9%	4.7%	2.7%	4.9%	4.1%
Risk	12.1%	21.1%	8.1%	4.4%	6.9%	0.3%	
Gulf War							
Return	11.7%	-1.2%	12.5%	12.5%	12.1%	7.0%	4.7%
Risk	19.4%	27.5%	8.4%	3.8%	6.7%	0.2%	

Source: "What Happens to the Market if America Goes to War?" By Mark Armbruster, CFA Institute.

War and Peace (and the Stock Market) *Cont'd*

While they also experienced lower levels of risk, they generated significantly lower returns than their long-term average. Strategically speaking, it only pays to be positioned defensively in the period leading up to a war. Once the war begins, your portfolio should be positioned more aggressively to take advantage of what will most likely be stronger equity markets.

In summary, equity markets tend to perform better during times of war, and do so with below average volatility. We are aware that volatility can be alarming and uncomfortable, but based on research it is better to be invested in the market in both times of war and peace over the long term. While we hope that future wars can be avoided we also realize that we cannot predict what the two polarizing leaders will do. Although it is tempting, trying to avoid the volatility beforehand will most likely lead to lost returns in the long run.

In an environment like this the best thing one can do is buy quality businesses that, despite all the market noise, are continuing to improve operations and grow.

By sticking to our strict investment philosophy, this is how we plan on navigating war and peace.