NAVIGATING THE CORONAVIRUS ENVIRONMENT

The Goizueta Business School
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Professor Dichev's MBA Investment Class

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KEY POINTS

- Psychological and human nature behavioral forces always play a large role in decision-making; those forces are especially powerful now

- Those forces are more important to successful investment decision-making than economics, accounting, finance, and quantitative analysis combined

WHAT MAKES THIS RECESSION AND BEAR MARKET DIFFERENT?

- The *suddenness* is unique, and it magnifies fear and insecurity
- Of course, there are the usual financial fears and anxiety
- But there are also health fears (the daily death count)
- Plus, there is a historic collapse of the oil market
- What may be most significant is small businesses (< 500 employees) represent ~85% of all businesses, and employ ~50% of the private sector working population; <u>that means the financial worry, and anxiety about job security, will be widespread</u> and impact consumer spending (2/3 of GDP)

***Key Point**: Because a significant component of the private sector works for small businesses, many of which have inadequate rainy day funds, numerous individuals feel deep worry and anxiety about their financial well-being.*

THE PSYCHOLOGY AND BEHAVIOR COMPONENT

- The suddenness of all of this is an over-arching force (scar tissue already)
- A negative wealth effect (due to financial worry) will play a large role
- Anxiety and worrying about one's health (death) is as natural as breathing; that instinct and resultant worry will also play a large role
- All this anxiety is exacerbated by sequestering, loneliness, and isolation (which increases stress); this anxiety/fear/worry will linger
- 40-50% of the private sector is connected to small businesses, which do not have deep pockets or months of staying-power cash reserves

- It is the combination of the above behavioral forces that potentially could be very damaging to the willingness to engage in commerce; to get out and spend

Key Point: *It is the suddenness and combination of these factors that could deepen and lengthen the recession and bear market.*

THE DEBT AND ILLIQUIDITY COMPONENT

- Many companies – large and small – have to navigate this sudden recession with high leverage
- Many companies do not have sufficient cash reserves (rainy day backup funds) to survive months of drastically reduced revenue
- Small businesses especially do not have rainy day funds to deal with closures and/or revenue levels that are 50% less than what is needed to survive
- The Small Business Administration may be too little/too late; and banks may not step in

***Key Point**: A heavy debt load and/or inadequate liquidity are serious threats to the survival of many companies; especially small businesses that are consumer spending or retail-driven.*

NEGATIVE ANIMAL SPIRITS +
NEGATIVE CONSUMER CONFIDENCE =
A STRONG IMPEDIMENT TO A QUICK ECONOMIC RECOVERY

The suddenness and pervasiveness of the coronavirus - and the psychological damage from reduced socialization (even isolation) - when <u>combined</u> with the financial damage from furloughs and closing businesses - will cause:

- Deep anxiety and financial insecurity, thus caution
- Reduced business investment (liquidity concerns)
- Reduced consumer spending (job insecurity)
- Significant contraction of demand for goods and services (consumer spending is 2/3 of GDP)

Obstacles to a quick economic recovery

***Key Point**: At the corporate and household level, a cautious, defensive, even fearful, mindset will dominate for at least a few months; thereby impeding a quick economic recovery.*

EVEN IF THE U.S. "RE-OPENS" IN MAY, PEOPLE MAY ONLY SLOWLY RETURN

- The re-opening will probably be gradual
- Continued safeguards will block economic recovery
  - Will waiters with masks and gloves be concerning/off-putting?
- Notwithstanding pent-up demand and cabin-fever, many, out of human-nature-instinctive-caution, will be reticent to immediately resume commercial engagement/activities; perhaps for months
- And many will not have cash to spend (even with government aid)
- Therefore, the re-opening will <u>not</u> be an "all clear signal" resulting in everyone jumping back in the pool; it will be a yellow flag, not a green flag
- If so, the economic recovery probably will not gain traction and normalize over the next 3-6 months; maybe not in 2020

***Key Point**: Surveys suggest most Americans plan to take a wait-and-see approach to returning to normal "getting out." Given the suddenness and severity of the last eight weeks, and the daily death count, it is logical many will <u>slowly</u> re-engage.*

THE POWERFUL IMPACT OF PSYCHOLOGY ON DECISION-MAKING

- *We know that suddenness* triggers a strong emotional response
- If not a panic response, a stop-wait-and-see response is triggered; a reticent/pause/slow down response
- In this environment, preservation becomes dominant
  - Protect and preserve your health and your family
  - Protect and preserve your source of income
  - Protect and preserve your savings, your wealth
  - Therefore, risk-taking is reduced, even rejected
- It is basic human nature to extrapolate recent trends/events; extrapolation of Covid-19 is now a powerful force

***Key Point**: These self-preservation instincts are hard-wired in all humans. It is almost impossible for most people – and most businesses – to not assume the risks and events of the last two months will continue for the next few months*.

THE U.S. IS NOT AN ISLAND

- Europe and most developed nations came into 2020 with weak economies
- Abroad, zero and negative interest rates have not been uncommon; that suggests weak demand
- China has been a huge source of global demand; that important source of demand has suddenly shrunk
- The supply chain is global; its disruption will continue to disrupt U.S. businesses – large and small
- Foreign demand for U.S. goods and services (including travel) will weaken for the same reasons they will weaken domestically

***Key Point**: America's businesses rely on, directly or indirectly, many non-U.S. suppliers and customers. In many instances, those non-U.S. suppliers and customers are struggling more than their counterparts in the U.S.*

CONVENTIONAL DECISION-MAKING TOOLS

- Especially when the environment is extraordinary and uncertain, the experts are looked to for guidance
- Forecasts and models are plentiful:
  - The coronavirus curve; when will it peak?
  - When will the U.S. be open for business?
  - How will consumers then behave and spend?
  - How deep and long lasting will the recession be?
  - When, and at what level, will the market hit bottom?

***Key Point**: It is natural, logical and almost automatic to latch onto the omnipresent forecasts of experts. It is almost unnatural to question their accuracy.*

FORECASTING REMINDERS
HOW ACCURATE AND RELIABLE ARE FORECASTS?

- Even in “typical” economic environments, forecasts often miss the mark (of course, so does WIC)
- Forecasts rely on many assumptions about the future, including about how consumers, businesses, and investors will make decisions
- This coronavirus environment/recession is extraordinary with little recent precedent to go on
- Because of the above, forecasting the next 6-12 months will be especially difficult; there is a wide range of possible outcomes; so forecasts must now be used with additional caution; including WIC

Key Point: *These forecasts are extraordinarily difficult to develop, and there is abundant academic research that questions their efficacy. Even those that understand that limitation, rely on them anyway; <u>there is a need to rely on something</u>.*

LIMITATIONS OF MODELS
(*Models Behaving Badly by Emanuel Derman)*

- Modeling, scenario analysis, and stress-testing are valuable tools used extensively by WIC
- But such modeling, including coronavirus curve and related modeling, has severe limitations, including:
  - What is being modeled may not be “modelable”
  - The critical inputs are often inherently unknowable
  - Models can be exceedingly seductive and therefore misleading
  - It is very easy to ascribe to models precision that does not exist
  - Humans <u>need</u> an explanation, so we rely too much on models

Key Point: *Of course modeling helps with evaluating possible outcomes and risks. The problem with a lot of modeling is not truly accepting the inherent limitations and thereby over-relying on the model for answers.*

VALUATION

- Valuing investment assets – real estate, private equity, stocks and bonds – is a critical element in evaluating risk versus return
- Valuation analysis is central to WIC's work
- Like forecasting and modeling, <u>valuation is also fraught with error and can be misleading:</u>
    - Key inputs are difficult to estimate
        - Margins and cash flow years into the future
        - Discounting rates; how do you handle zero or near-zero interest rates
    - Long standing historical relationships can change
        - Stock versus bond returns
        - Interest rates and bond yields versus inflation
    - Patterns that appear predictive often are misleading
        - Disruptive forces
    - Short-hand valuation metrics are often too simplistic
        - PE multiples when GAAP earnings understate economic earnings

THE MOST POWERFUL BEHAVIORAL INFLUENCES ARE NOW "IN CONTROL"

- In addition to the heightened risks of now relying on forecasts, models, and valuation metrics, the power of psychological/behavioral influences are likely now especially dominant in decision-making:
  - Extrapolation
  - Over-reliance on easily available information
  - Social media posts taken as fact
  - Thin-slicing without closely reading for facts
  - Relying on a small sample size (anecdotes; case rate vs. base rate)
  - Stories and narratives latched onto as fact/predictive
  - The powerful human nature need for an explanation, even if the explanation is merely plausible (humans often don't require facts)

***Key Point**: These forces are easy to dismiss with "I am too smart or savvy to make those mistakes." In fact, these forces are pervasive and incredibly powerful.*

ENGINEERING VS. INSTINCTS

- Relying on one's instincts, art, and judgment seems reasonable, but that may be too susceptible to emotion (prior slide)

- Although math, engineering, models, algorithms, etc. can reduce the power and influence of emotions on decision-making, <u>they cannot eliminate the insidious and often hidden influence of human emotion</u>

- So what is the "right" balance of art and science, instinct and engineering, judgment and math?

Key Point*: The right balance is elusive. Perhaps the key point is "balance".*

WIC'S DECISION-MAKING BEACONS FOR THESE TYPE ENVIRONMENTS

- Picture how a dense fog makes it easy to get lost
- The uniqueness of this environment, and the insidious psychological forces, are part of the fog
- Therefore, reliable decision-making beacons are critical
- First and foremost, <u>do no harm</u>
  - Don't over-react (but don't under-react); resist urgency
  - Don't sell securities in response to uncertainty
  - Don't act boldly or quickly; take measured steps
- Double-check assumptions and calculations (but remember their limitations)
- Take time to think rationally; proceed slowly to enable rational thinking
- Allow time to reveal the right path

Key Point*: Granted, it sounds so simplistic. But when the environment is emotionally charged, and the range of possible outcomes is very wide, it is critical to take time to think rationally and to make decisions slowly (Kahneman).*

MORE SPECIFICALLY…

- Re-evaluate our clients' liquidity needs
- Re-evaluate our clients' asset/strategy allocation
- The companies we own for our clients:
  - Double-check their balance sheets
  - Stress-test debt service coverage and covenants
  - Stress-test liquidity
  - Rethink reliability and level of free cash flow
  - Update our valuation models
- Deploy excess cash; be appropriately aggressive
- Don't over-react to monthly, quarterly, or annual returns
- Stay in closer touch with clients; counsel

WIC's ART AND SCIENCE DECISION-MAKING RULES

- Debate is required; counter-points are critical
- Triangulate
- We cannot calculate or model the answer
- The precision we want does not exist
- Instinct and common sense are as important as math
- Be skeptical, but don't slip into decision-paralysis
- WIC is 41 years old – draw on that experience and instinct
- Continue adhering to WIC's gradualism discipline

***Key Point**: <u>Gradualism</u> embraces Daniel Kahneman's Thinking Fast and Slow; reflects WIC's belief that psychological errors are insidious; and accepts many of the inputs to valuation and other investment decision-making models are inherently imprecise, even unknowable.*