Twitter Thread by Kirubakaran Rajendran

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Year 2022 has been disastrous for many asset classes, the world economy is at 40 year high inflation. Are we headed for another stock market crash? Here's a detailed analysis. ■



Emerging markets like SriLanka is in middle of collapse, which is facing severe depression. World Bank has predicted 70 more countries might default in coming years. With so many negative news, from equity to bitcoin every asset class facing severe sell off across the globe.

Everyone is currently talking about Inflation, rise in oil prices, Russian-Ukraine war and frequent lockdowns in China which is disrupting the supply chain. These are some of the major threats which could slowdown the world economy. But will these cause a stock market crash? No!









@morganhousel, author of The Psychology of Money was once said

"The biggest economy risk is what no one is talking about. When no one is talking about it, no one is prepared for it. When no one is prepared for it, damage is too much."

COVID-19 no one in the world expected such a pandemic in the modern world, no one thought we would get locked down, entire world would get shut. This is mother of all surprises, no one was prepared for it.

2008 Global Financial Crisis, none of the large institutions were prepared for it, they never though mortgage crisis could cause such a severe damage to the economy. The whole world collapsed.

9/11 Attack - No one on earth would have thought such a terrorist attack would be possible on one of most powerful country in the world. Market tanked and it was shut down for weeks when the plane hit the twin towers.

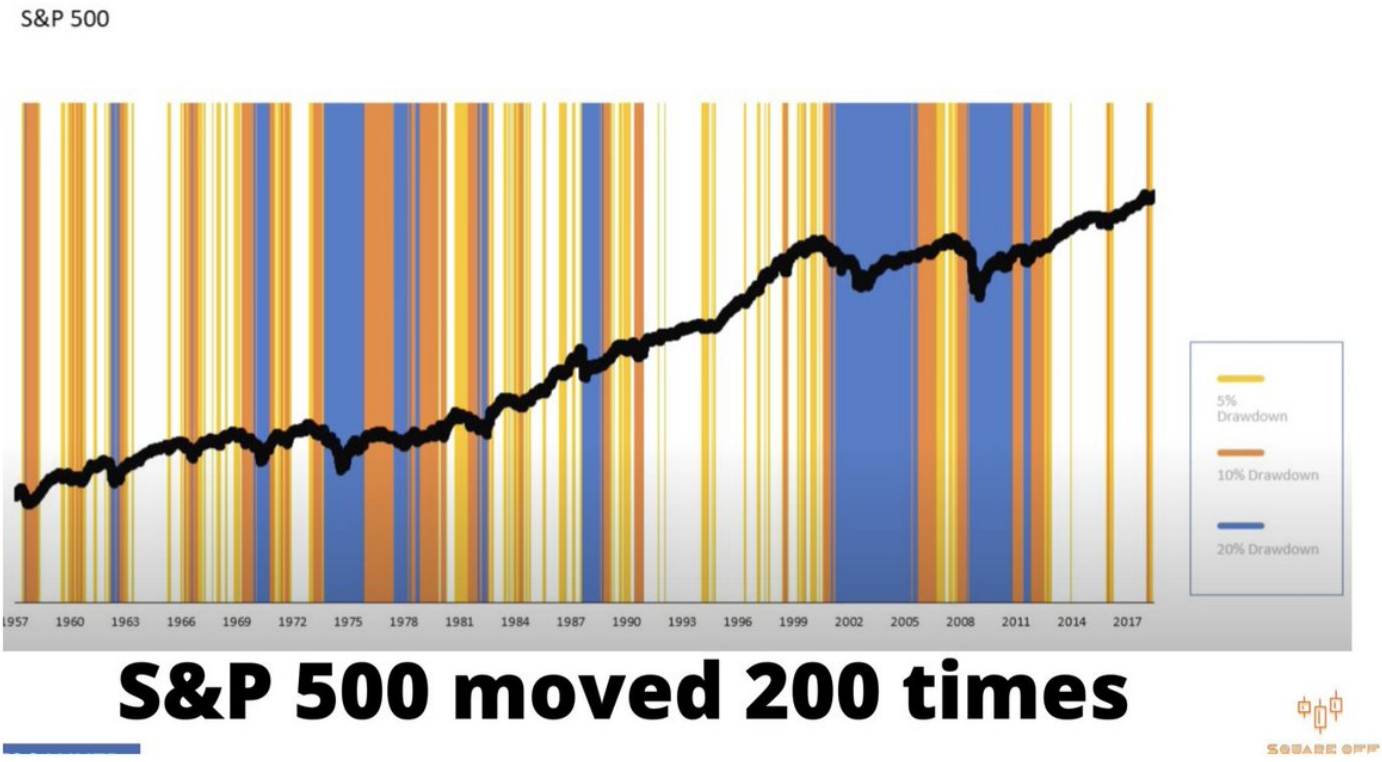
All these events were totally unpredictable and we were never prepared for such instances, these things cause extreme panic and that's when crash happens.

"Risk is what is leftover, when you think you have thought of everything."

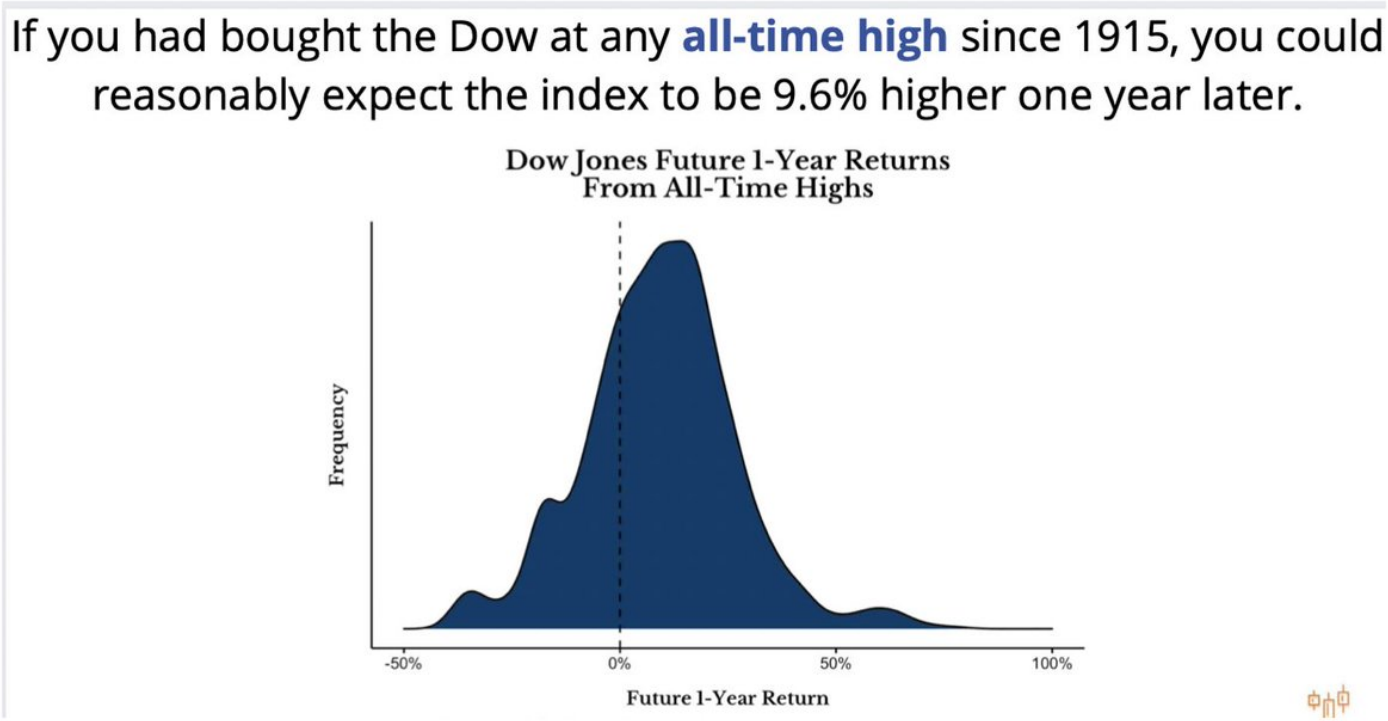


Lets' look at the historical data analysis of S&P 500 index. From 1957 to 2017, it made 200 times returns. But if we dig deep, we can see the market has gone through lot of intermittent corrections.

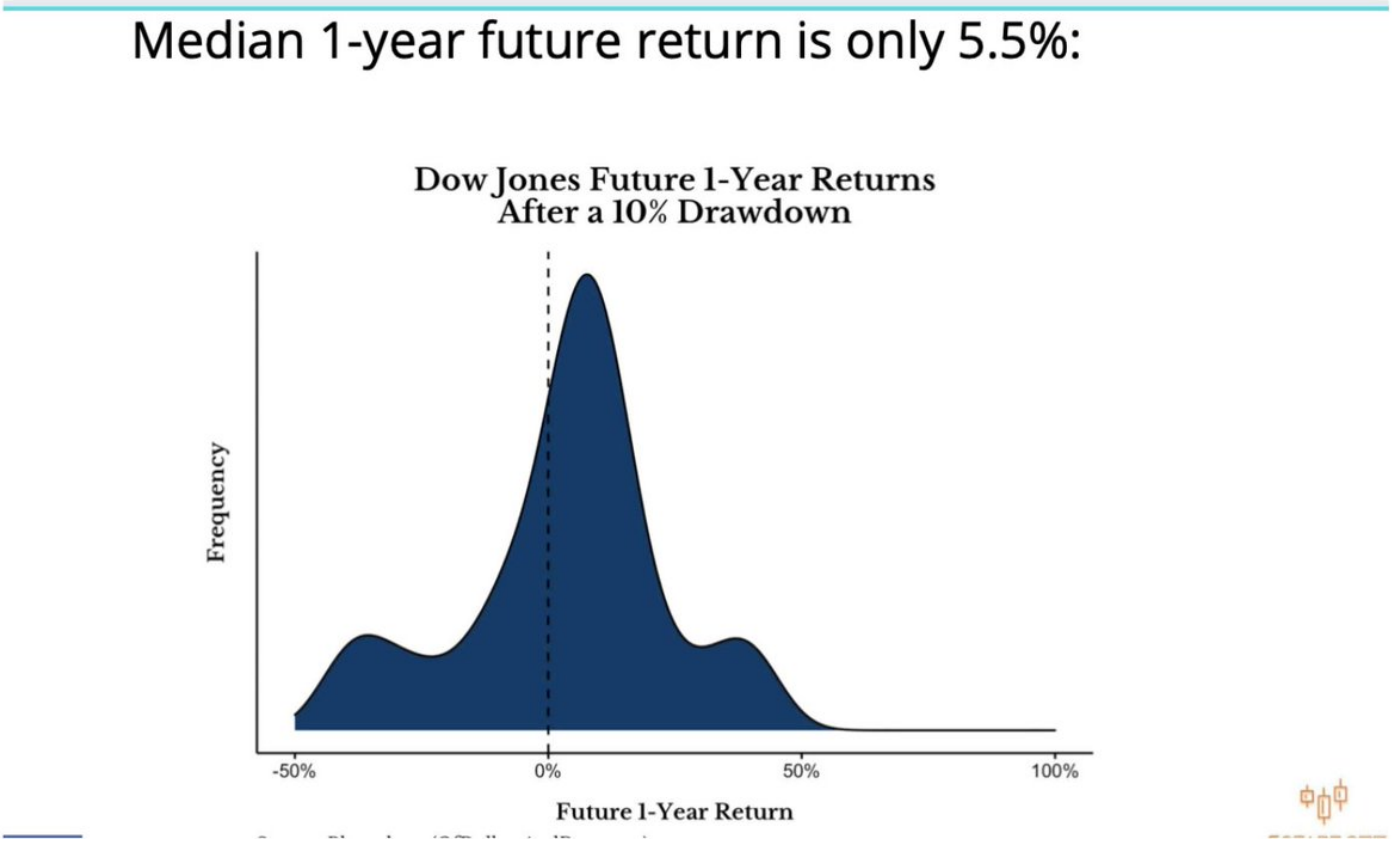
more than 8 instances market corrected more than 20%. Inspite of all that, only direction that it went in the long run is upside. When you are staying invested for a long period, your risk factor goes down to a greater extent.



There was an interesting quantitative study made by @dollarsanddata Nick Maggiulli author of "Just Keep Buying". With 100 years of historical Dow Jones data, if you had invested at any of the all time high period, the next one year median returns to be around 9.6%.



Whereas if you have invested in Dow Jones after a 10% fall from its all time, then the next one year median returns was just 5.5%. when there is a good momentum in market on the upside, it continues to move up even if the valuations were stretched,

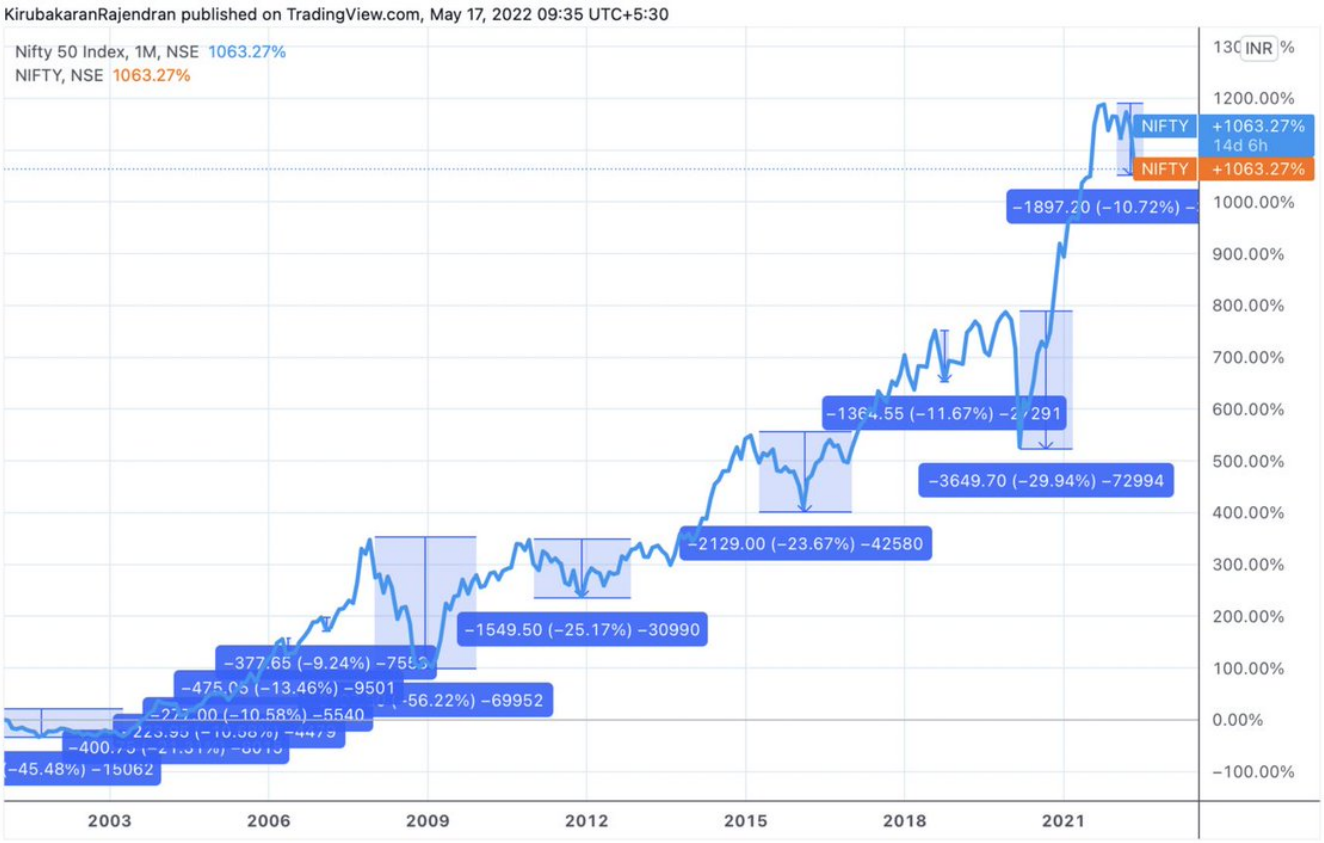


Once downward momentum kicks in, it might not stop at 10% drawdown, the market might continue to slide. A 10% drawdown might end up in a 50% drawdown as well when things gets worse. So the average returns goes down in the following year when you invest at a 10% drawdown.

Let's look at the historical crashes in Indian stock market. Nifty index made 5200% returns since 1992, but there were many instances during this 25 years period where market declined more than 50%.



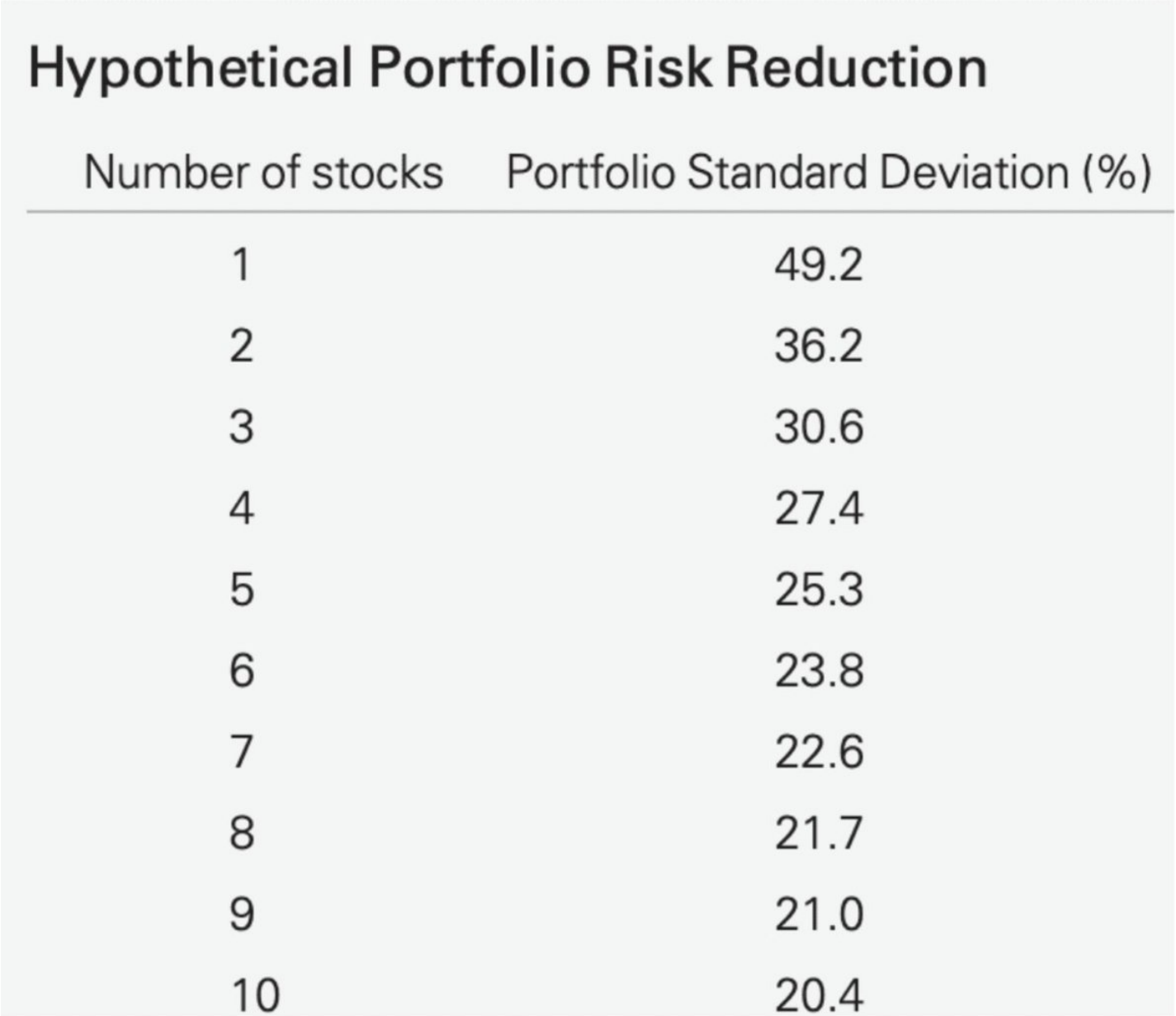
Since 1995, there have been 17 separate 10% declines in the Nifty. So number of times we have seen such a broader market correction of more than 10% is very normal that happens very frequently when the valuations are stretched too much.



What happens after these down move? On every single instances after such a sharp sell off, market rallied significantly in the following years.



Diversify:
There is no way we can avoid such down turn, but we can control the damage to a greater extent by diversifying with multiple stocks. If you can diversify your portfolio with 5 stocks, then you are reducing the standard deviation of your portfolio to 50%.



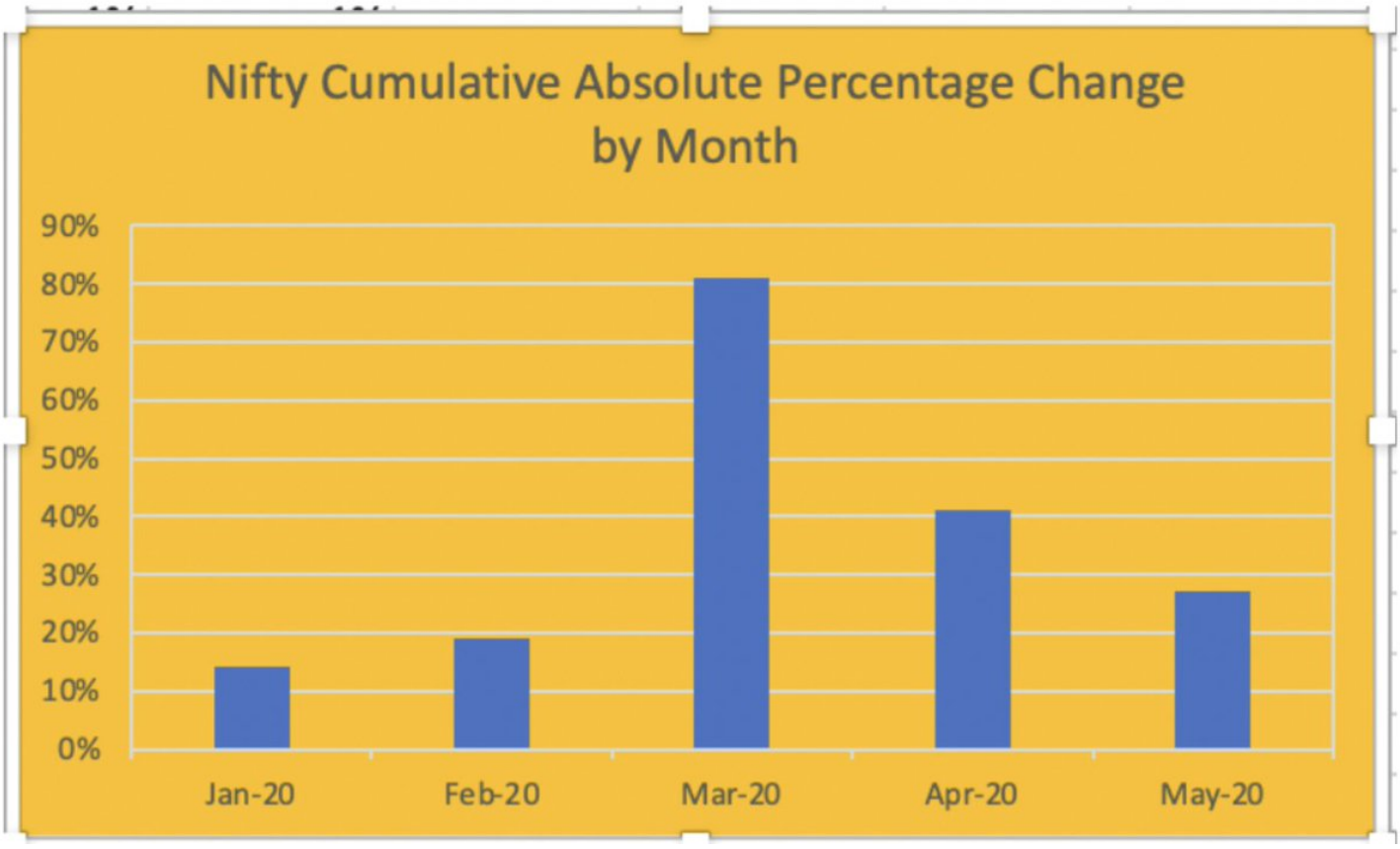
Hypothetical Portfolio Risk Reduction

Number of stocks	Portfolio Standard Deviation (%)
1	49.2
2	36.2
3	30.6
4	27.4
5	25.3
6	23.8
7	22.6
8	21.7
9	21.0
10	20.4

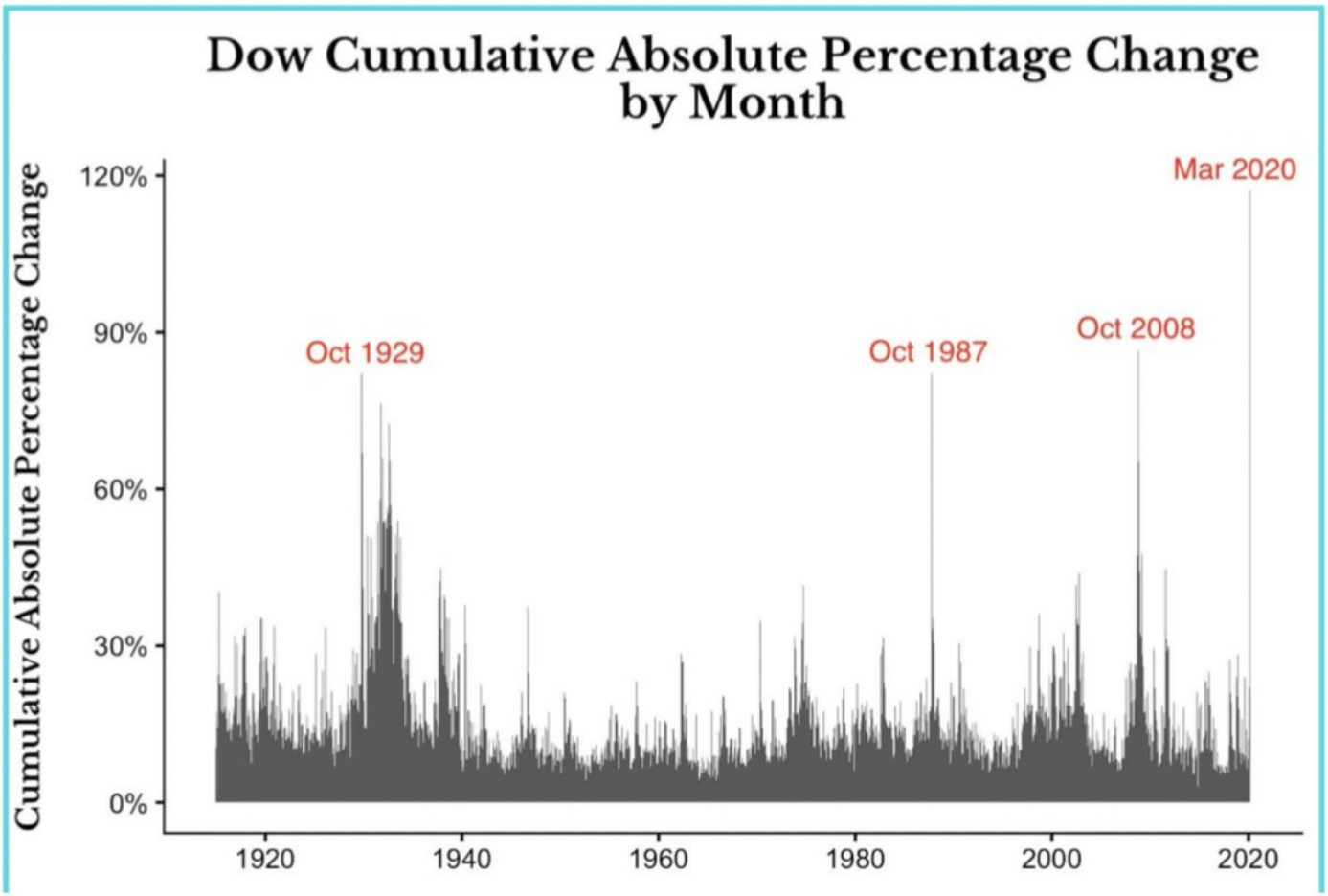
The more diversified stocks you have in your portfolio lesser the volatility will be. And lesser the volatility, you tend to panic less and hence you will stick to your investments and sail through drawdown phase easily.

Many people were comparing 2022 to be the start of year like 2020. No, year 2020 was at the extreme end. I did a quantitative study on Nifty index, where I checked the daily absolute returns.

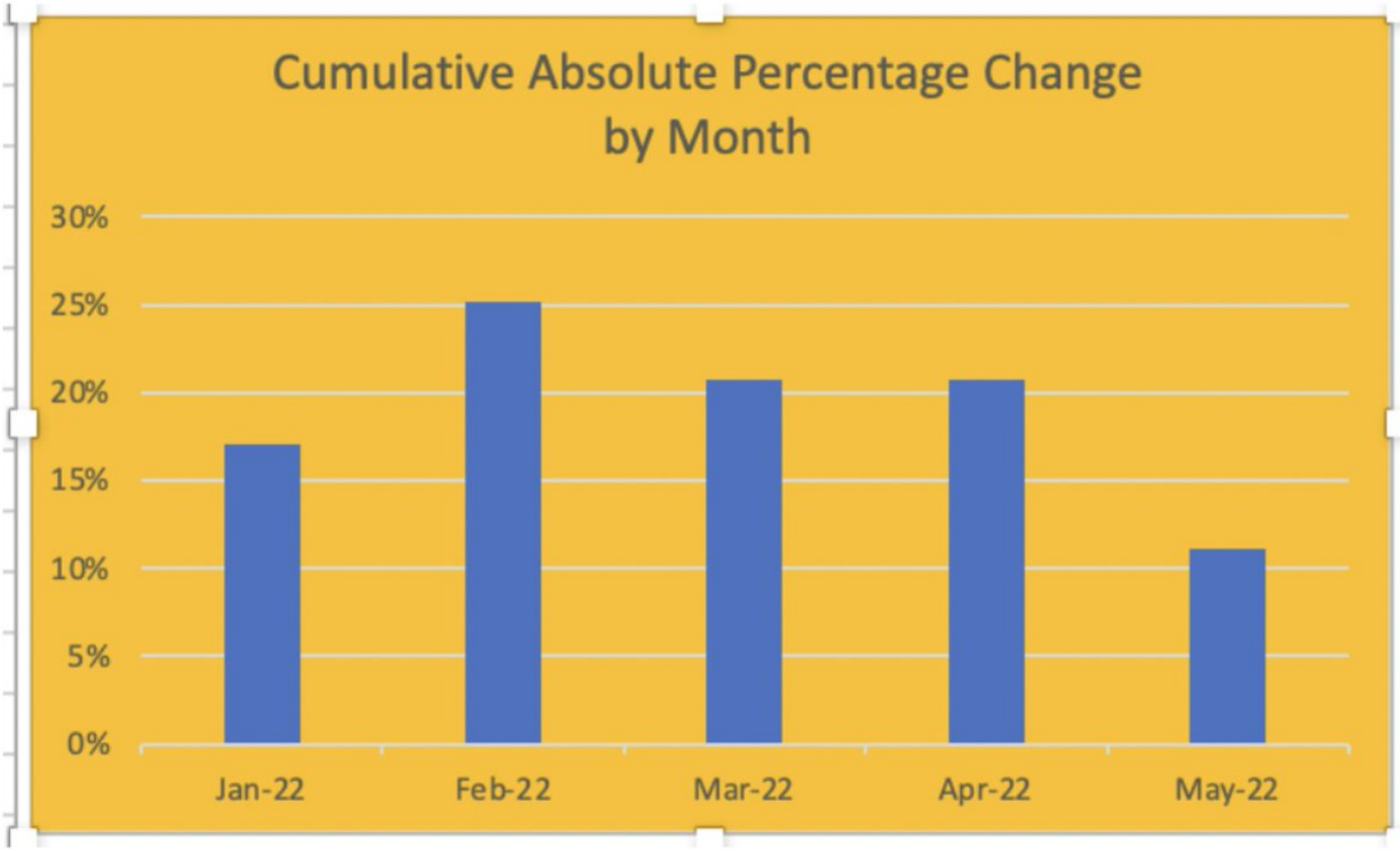
For example, if todays daily returns is + 1.5% and tomorrow if its -2.5%, then total absolute returns is 1.5+2.5=4. Likewise I calculated the daily absolute returns for the period of Jan - 2020 to May 2020. This shows how extremely volatile March 2020 was.



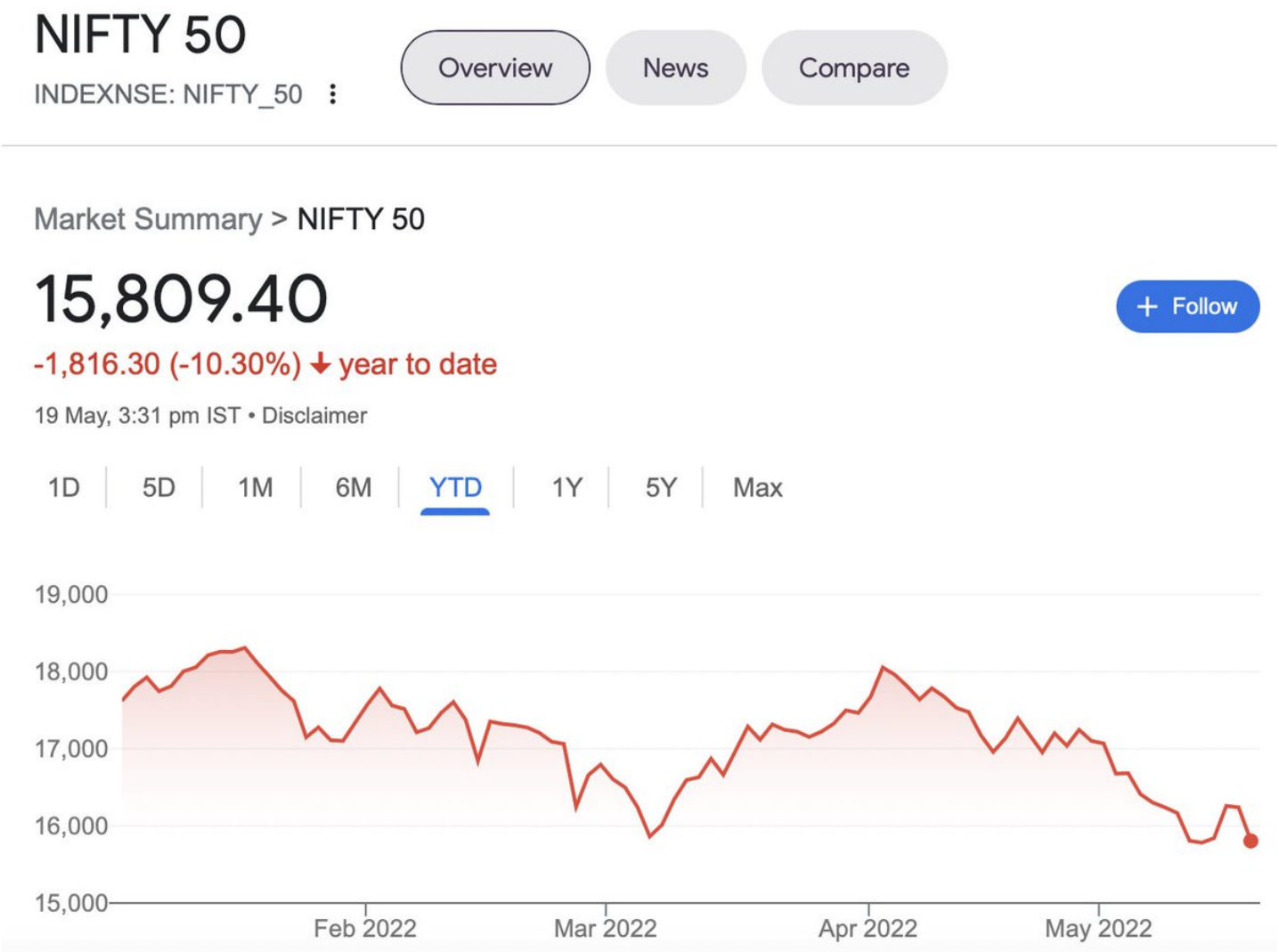
There was a similar study done by Nick Maggiulli with Dow Jones with 100 years of data, even US market recorded the highest ever absolute returns in year 2020, which was greater than 1929 Great Depression.



We are no where near any such extreme volatile end. In fact, the extreme movements in markets is getting narrower each month. Probably we might slowly start up move in the coming months.



We aren't falling much compared to Nasdaq because they are filled with many tech companies, our indices aren't filled with such companies. Companies like TCS, INFOSYS, WIPRO, HCL are extremely cash rich companies and very stable. That's why our indices has corrected only 10%.



Only thing that could save us from such extreme down move is to keep a diversified portfolio that can bring down volatility to the greater extent. No matter what kind of corrections happens in the market, it always tends to move up in the long run. As they say,this too shall pass

Here's the link to the detailed article. https://t.co/r90urjLLxL