Recession-proof Your Portfolio in 5 Steps

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In recent months, talk of a recession has been gradually increasing on the back of deteriorating global macroeconomic data. While many countries have not officially entered a recession (which is defined as two consecutive quarters of negative quarter-on-quarter growth), the signs are ominous that it would – sooner rather than later. Given this, what should investors do and how should they position their portfolios? Below, we outline 5 things an investor should take note of as we potentially head into a recession.

#1. Ensure your portfolio risk matches that of your risk profile

Over the years, one's portfolio may have changed. This could be due to conscious actions to switch holdings or even because of a change in the value of the investments. Oftentimes, this leads to a change in the portfolio's overall risk – in some cases making it less risky or in other cases, more risky. What an investor doesn't want is to be shocked that, in the midst of a recession-led sell-off in markets, his portfolio is carrying much more risk than what his risk appetite could tolerate. So an assessment of these two – the portfolio's present risk versus the investor's risk profile – will highlight whether a mis-match is present. Urgent changes before the recession hits are needed to re-align them.

#2. Ensure your portfolio remains diversified

Diversification reduces risk. As such, investors should ensure that their investment portfolios are well-diversified when going into a recession. Diversification can occur at many levels. For example, there could be regional diversification where one's portfolio should have an allocation to all 3 major regions: the US, Europe and Emerging Markets. Diversification can also occur on a sectorial basis. For example, one might want to ensure that the technology sector does not carry too heavy a weighting compared to other sectors. One of the most effective ways to diversify is through unit trusts, which typically have 20-50 different stocks in their holdings. Investors can also reduce the overall risk of their portfolios by investing in what is known as "non-market correlated assets" – investments that have no correlation to traditional holdings like stocks and bonds.

#3. Have a plan

Even if you have correctly positioned your portfolio in terms of risk and have ensured your portfolio is well diversified, have a Plan B. This is the plan which outlines when any action should be taken if things turn out very differently from what was initially envisaged. For example, if markets suddenly start losing a lot of ground over a short period of time, investors may set a 20% loss trigger, below which they would switch to, say, a 100% bond portfolio. The same goes if markets suddenly makes a strong move higher. Even a plan to stay put and ride the volatility is in itself a plan but needs to be set before the event. Having a plan ensures that we follow well thought through actions rather than panic and base our actions on emotions especially fear. History tells us that fear often results in very bad investment decisions, such as selling at the lows.

#4. Look to hold quality investments

Recessions are defined as periods of lower economic activity due in part to less consumer spending and an overall loss of confidence. Recessions are also where many companies will find themselves struggling, for example, because of lower revenues or from having taken on too much debt. Defaults, which is how companies might go bankrupt, tend to spike up during recessions. Because of this, it would be prudent for investors to hold onto so-called quality investments which have a much better chance of surviving a recession. These are either stocks or bonds of corporations or other entities which are of a better credit quality, and thus their probability of default is lower compared to the rest of the market. For instance, in the equity space, this could refer to blue chip companies which may have monopolistic or oligopolistic powers such as telco companies. In terms of bonds, investors are advised to stick to higher grade bonds – those that may fall within the A rating category (AAA, AA, A-rated bonds).

#5. Reduce leverage

It would be wise for investors to reduce their leverage if they have taken up credit facilities when purchasing their investments. These include leverage provided by financial institutions to buy stocks or even bonds. Leverage works both ways. In a rising market, leverage helps to provide an added boost to returns (for example +30% with leverage versus +10% without leverage) but in a falling market, leverage can compound the losses of an investment (for example -30% with leverage versus -10% without leverage).

In summary, investors should not fear recessions as this is a normal phase in the economic cycle that comes after an expansionary phase. As long as investors are prepared for it and position themselves accordingly, recessions are actually great opportunities to pick up bargains and to position oneself ahead of the upswing when it comes.

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