keeping an eye on finance

focus

Issue: Autumn 2008

Patience makes a fortune!

“The farther backward you look, the farther forward you can see.”
Winston Churchill

Welcome to the latest edition of Focus. In recent months Australian and world share markets have experienced some market volatility. During these times it is important to remember that a level of unpredictability is a fundamental feature of market cycles that occurs from time to time. In this issue we concentrate on weathering the storm of volatile times and examine some top strategies.

History has shown that sticking with your investment strategy when times are difficult as opposed to panic selling when markets have fallen, or are falling, can pay off handsomely provided:

- high quality assets are held
- well diversified investments and
- you don’t change your strategy from long term to short term in the middle of a market downturn

The psychological phenomenon which always rears its ugly head regardless of whether the market is ‘bullish’ or ‘bearish, is that of ‘Fear and Greed’.   Learn to use these emotions for your benefit and remain focused on your objectives.

History reveals many examples of investment markets experiencing sharp declines only to recover, and go on to greater heights.

As always, if you would like more information on any of the topics in this newsletter, or any other investment advice, please feel free to contact one of our experienced and professional advisers.

in this issue

Given the volatility in financial markets, we thought it appropriate to devote the entire newsletter to this topic and provide you with top strategies.

Words of Wisdom

‘An investor’s worst enemy is not the stock market but his own emotions.’

Warren Buffet

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Volatile times – weathering the storm

Market volatility is not new. Consider 16th century Holland, which under the grip of tulip mania, experienced tulip prices equivalent to houses. Or the Australian share market rising 88% in the 12 months to September 1987, while underlying profit growth over the same period was just 25%.

Why do markets experience bouts of volatility which exceed that justified by fundamental information flow? Experience and observation tell us that investors have a tendency to act irrationally. Emotions such as fear and greed can get in the way of good decision making based on fundamentals.

A distinctive feature of market psychology is the 'herd' instinct, that is, if others believe, it is safe also to believe. The herd mentality is fuelled by market commentators, with the short term focus of commentary at odds with the longer term investment horizon of most investors. Prices are driven up by irrational exuberance, becoming dislocated from fundamentals, while a 'this time it's different' attitude prevails. Investors do not want to get left behind.

Just as exuberance can drive the upswings, panic and fear drives the sell-off. Studies which have analysed the stock market crash of 1987 indicate that for many individual and institutional investors, no news event, other than news of the crash itself, precipitated their sell-off. For over-emotional investors, the age-old principal of 'buy low, sell high' is more often than not followed.

Volatility over time

Moving in and out of markets is a risky strategy – just look at the negative effect on overall return if you had missed the best 10, 20 or 30 days of performance of the S&P/ASK300 Index from June 1992–December 2007.

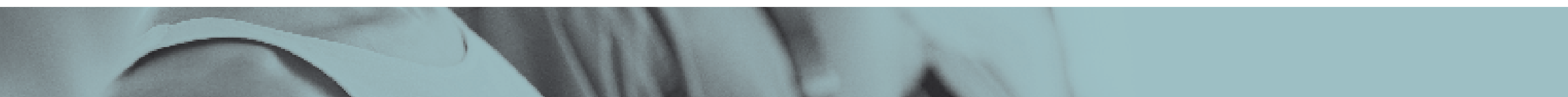
At the time of the 1987 crash, the Australian share market was amongst the most volatile of the top 20 international markets. The deregulation of the banking industry and opening up of the financial markets in the early 1980's led to overly abundant credit, which fuelled previously unseen levels of enthusiasm in the share market. In just five years to September 1987, the Australian share market climbed 420%! Moreover, in just 12 months to September 1987, the market rose 88%. At the same time, profit growth was running at 25%. Clearly the price of shares was becoming detached from its underlying fundamentals. However, excessive exuberance was quickly replaced by pessimism. Tuesday 20 October saw the market

Market Timing is Risky

S&P/ASX300 Accumulation Index – June 1992 - December 2007

Annualised Return: June 1992 - December 2007

	Total Period	Missed 1 Best Days	Missed 5 Best Days	Missed 15 Best Days	Missed 25 Best Days	UBS Bank Bills	UBS Composite Bond Bank Index
Annualised Compound Return	13.4%	13.0%	12.1%	10.4%	8.9%	5.8%	7.5%



plunge 25%, the biggest ever one-day fall in the Australian share markets. From the high in September 1987, to the low in November 1987, the market came off 50%.

Volatility and investment options

Risk and return is the inevitable trade-off with investing. If you are too aggressive you face the potential risk of losing a large amount of life savings that you may never recover in your investing lifetime. On the other hand, if you are too risk averse, you may not build sufficient capital growth required at some stage to generate a sufficient income stream in your retirement.

Those investors who ignored risk and volatility and dived into high tech stocks in the 'dot com' boom, believing 'this time it is different', lost a great deal of money. For those investors who rely on an income stream from their savings, the cost of volatility is even more real.

It is also worth highlighting volatility is only one indicator of risk and, as usual, stable past performance of a fund is not necessarily a guarantee of future stability. Unforeseen market factors can influence volatility. The fallout of the US sub-prime is a great example of this.

Top strategies in volatile times

1. Diversification is the key to enhancing performance while at the same time reducing volatility in the overall portfolio. You can reduce portfolio risk by:

- diversify across asset classes
- within asset classes, diversify across investment styles
- diversify across managers within the different investment styles as even the best managers do not stay on top forever

2. Education as you need to understand and be prepared for volatility. Remember that to achieve long term growth you will need to endure volatility in the short term, and that as long as the right investment option is chosen to begin with, you can ride out the bumps.

3. Time in the market rather than timing the market. Given that the strategic asset allocation accounts for up to 90% of the variability of returns, much effort goes into getting the mix of assets suitable to meet your long term goals. There is little evidence to suggest that market timing at the asset class level will add value over the strategic (long term) asset allocation over a full market cycle. It is best to avoid knee-jerk reactions in volatile times. Remember, you are investing to meet a long-term goal, not avoid a short term loss. A shift from the strategic asset allocation can be detrimental to your returns and may increase real (rather than perceived) risks considerably.

4. Capital protected strategies. Investors approaching retirement need to continue to hold growth assets to grow their savings. However, they may be uncomfortable with the prospect of capital losses in volatile environments.

5. Dollar Cost Averaging, is a strategy involving the investment of fixed amounts of money into the markets at regular intervals, regardless of market conditions. Given it is difficult to predict the future, averaging into the market reduces the risk of investing at the top. Followed strictly, this strategy helps remove emotional decisions, making it easier to stick to a long term investment plan.

6. Rebalancing as left alone, portfolios will drift outside desired asset class and investment manager ranges, especially in volatile times. The result is a portfolio which may no longer meet your needs in terms of risk and return. Rebalancing at regular intervals ensures the portfolios risk and return profile is retained while removing decision making based on emotion. Rebalancing should typically occur during your portfolio reviews when conducted in conjunction with one of our experienced and professional advisers.

As always, it's important to seek professional financial advice. If you would like to explore the above strategies in more detail, please contact us at any time.

VOLATILITY IS THE PRICE YOU PAY FOR INVESTING!

Let's look at historial returns from January 1971 to March 2008. Even a well diversified investment has pros and cons to consider.

Conservative Investor Type Portfolio	
Average Historical Return per annum	10.05%
Worst return over any 12 months	-7.29%
Best return over any 12 months	27.86%
Historical incidence of negative return every	1 in 21.80 years

Moderately Conservative Type Portfolio	
Average Historical Return per annum	11.56%
Worst return over any 12 months	-16.61%
Best return over any 12 months	36.62%
Historical incidence of negative return every	1 in 8.55 years

Balanced Type Portfolio	
Average Historical Return per annum	12.74%
Worst return over any 12 months	-23.66%
Best return over any 12 months	45.00%
Historical incidence of negative return every	1 in 6.51 years

Growth Type Portfolio	
Average Historical Return per annum	13.80%
Worst return over any 12 months	-29.73%
Best return over any 12 months	52.45%
Historical \incidence of negative return every	1 in 5.59 years

High Growth Type Portfolio	
Average Historical Return per annum	14.59%
Worst return over any 12 months	-34.15%
Best return over any 12 months	56.64%
Historical incidence of negative return every	1 in 5.13 years

* This information has been sourced from Van Eyk Research. The investment returns are before fees and taxes. The above figure illustrate past performance and do not guarantee future results. This information should not be relied upon for making any financial decision.

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