

# Australian Market Falls Can Seem Much Worse Than They Need To Be

The recent falls in equity are not the worst in recent memory and it is inadvisable to make snap decisions on investments

While it is reasonable for investors to be disappointed with the state of the markets, even the state of their portfolio, but they should not be surprised. History shows that this correction is not the worst on record.

Losses are more painful than equivalent gains for most investors. Consequently it is better wherever possible to focus on portfolio outcomes rather than the movements of individual stocks or funds with investors. This may be even more relevant to investors who have a low risk tolerance score.

In the lifetime of a portfolio there will be infinitely more bad news stories for investors who look at their investments in a disaggregated manner compared to the ones who simply look at the overall balance.

In the next few months there will be much confusion regarding the short to medium-term performance of the world's equity markets. Some investors will have partially or fully exited the market in order to buy back in when prices are 'stable'. Other investors already contemplating exiting their equity investments may see this as the last straw. There will be others still who had not thought of selling but will now panic and sell at whatever price they can achieve. All are market timers. Attempting to time the market and panicked investment decisions are perhaps the two greatest enemies of investors' wealth.

The latest market volatility research by FinaMetrica looked at the four greatest All Ords falls of the past 40 years and examined how diversified, rebalancing portfolios behaved compared to just the performance of the All Ords.

In three sections our analysis shows what we can learn from performance benchmarking, how a typical portfolio would have behaved through the major corrections since 1972 and some practical insights into investor management through a behavioural finance prism.

## Five history lessons

- The call by investment pundits that 'this time it is different' has rarely been correct. Markets have invariably recovered.
- Instinctive market reactions tend to destroy investment value. There is ample evidence that investors on average receive a significantly lower return than the market reports. This is because they generally enter and leave at the wrong times. They often sell on reports of large declines and tend to buy when everyone else has made money.
- Figuratively speaking, keeping the money under the bed does not work. Being always out of the market and invested in bank deposits keeps investors just ahead of inflation. Sometimes the outcome can be much worse depending on timing and taxes.
- Holding an 'all equities' portfolio is rather like living on the back of a bucking bronco. Only comfortable for investors with more than an iron will.
- Investing with discipline has worked. The table shows three portfolios taken from the FinaMetrica Risk and Return Guide AUS compared to three benchmarks - inflation, bank deposits and an all equities portfolio. Diversified asset allocations with 30 per cent, 50 per cent and 70 per cent growth assets, rebalancing once a year, have delivered reasonable average returns. This has been better than inflation and term deposits. And they have done so with lower than pure equity risk volatility.

Average Annual Rolling 10 Year Returns

Inflation	Term Deposits	30% Equities	50% Equities	70% Equities	100% Local Equities
5.5%	8.6%	11.6%	12.3%	13.0%	13.7%

[Rebalancing once per annum since 1972]

These are of course the average returns. Markets do not run this smoothly. What is infinitely more challenging for investors is coping with the extreme events associated with investment markets. Let us look at some of the extreme events since 1972 and how many months each portfolio would have taken to recover.

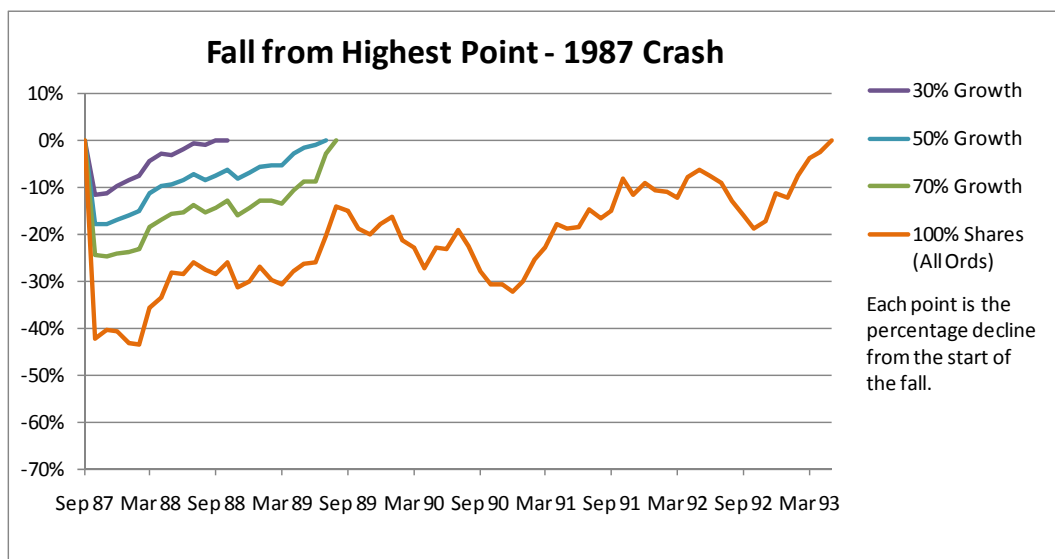
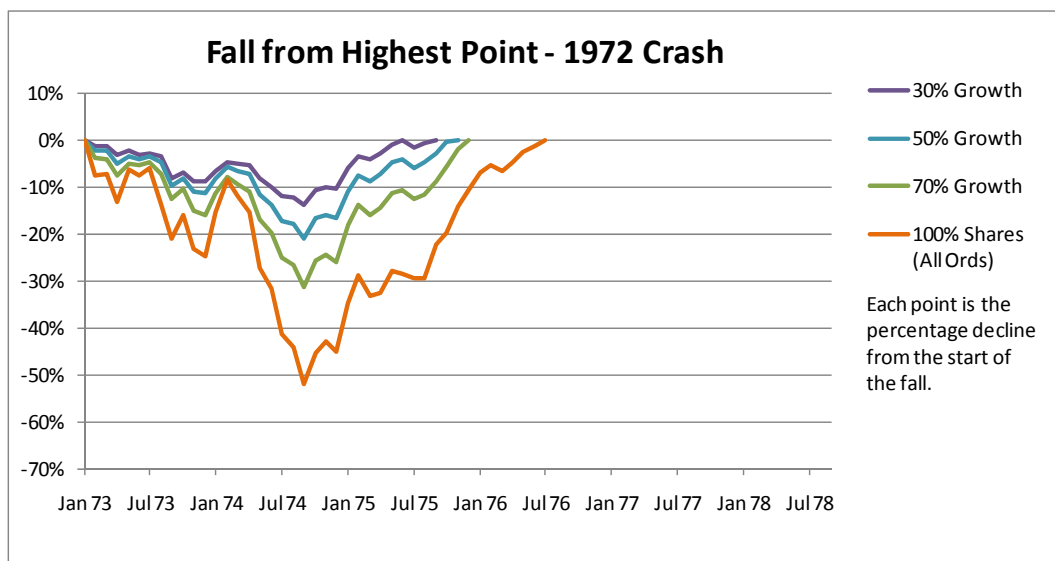
## The four largest falls since 1972

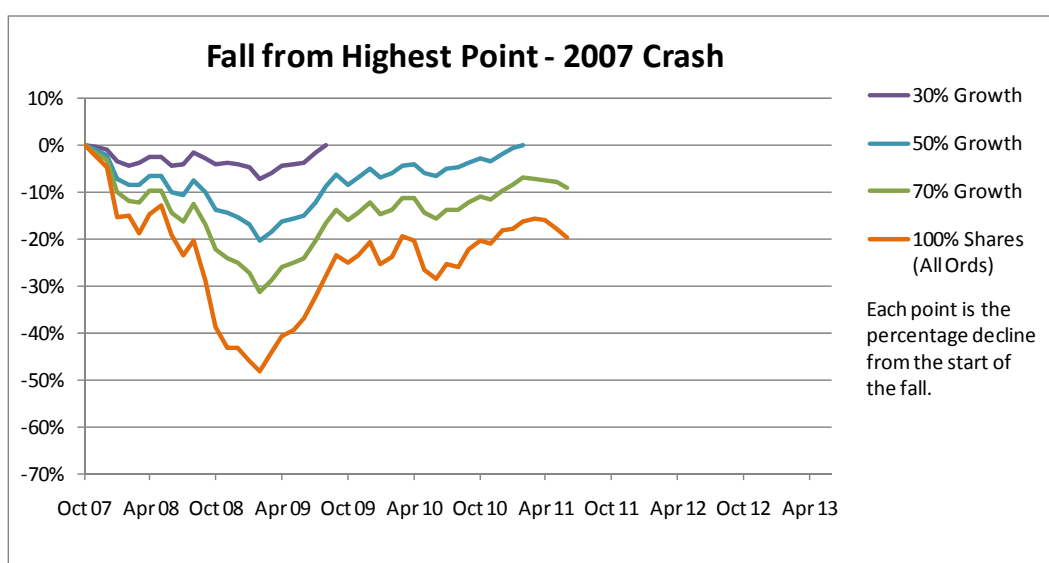
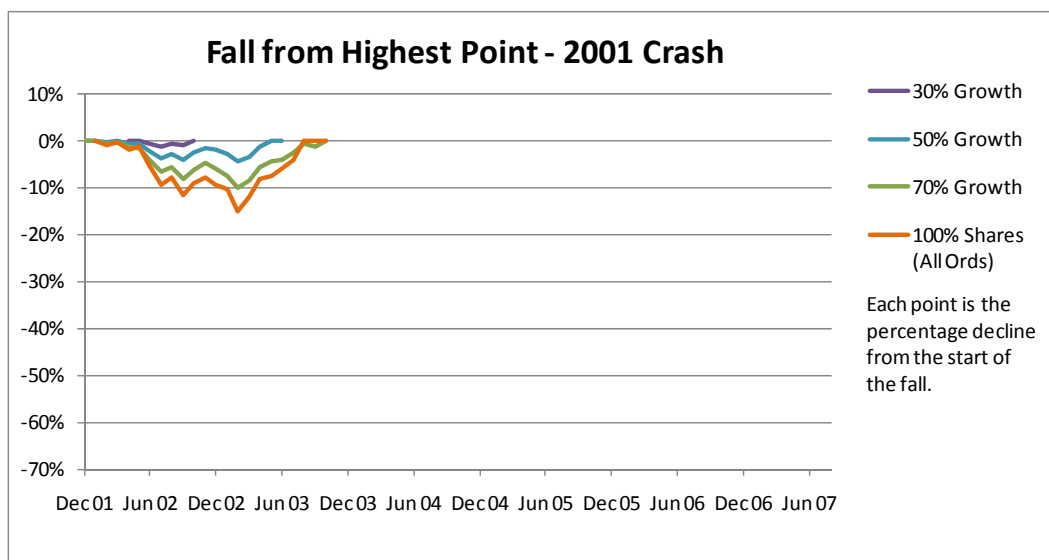
% Equities											
30			50			70			100		
Top 4 Falls (depth and months to recover) 1970 - 2011											
Depth	Start	Mns*	Depth	Start	Mns*	Depth	Start	Mns*	Depth	Start	Mns*
-13.9%	Feb 73	12	-21.0%	Feb 73	14	-31.3%	Feb 73	15	-51.9%	Feb 73	22
-11.6%	Oct 87	12	-20.4%	Nov 07	24	-31.2%	Nov 07	28^	-48.3%	Nov 07	28^
-7.2%	Nov 07	6	-18.0%	Oct 87	20	-24.9%	Oct 87	21	-43.5%	Oct 87	63
-5.7%	Feb 94	5	-7.7%	Feb 94	3	-13.0%	Jun 81	7	-33.4%	Dec 80	16

\* Months to recover ^Recovery not completed

Of particular note is that the most recent falls have not been the worst in recent history and equity performance does not always dominate portfolio performance.

The graphs show both the drop and recovery period of portfolios with 30 per cent, 50 per cent and 70 per cent equities against the All Ords TRI in recent major market falls.





Behavioural finance research highlights some issues for IFAs when dealing with clients:

- An investor's initial comfort with investment returns is often anchored on the highest value achieved in the past. To better cope with the likely lengthy time to recovery, investors with higher exposure to growth assets should be reminded of how long it took in previous market corrections for portfolios to reach the bottom of their descent and then return to previous highs.
- Investors tend to focus on recent events. It is almost always worth sharing with investors a brief history of portfolios consistent with their own to put the current correction into a longer term, personal context. Economic indicators such as consumer and business confidence, gross domestic product growth, unemployment and interest rates will be watched intensely in coming months. It is therefore important to bear in mind that at times such as these it is nigh impossible to make accurate economic assessments and therefore any forecasts are questionable. The emotional responses of investors that already play a large part in how markets move will be exaggerated by every new bit of news. The best way to approach this situation is to encourage them to try and block out the short-term 'noise' and focus on the medium and long-term scenarios.
- Losses are more painful than equivalent gains for most investors. Consequently it is better wherever possible to focus on portfolio outcomes rather than the movements of individual stocks or funds with investors. This may be even more relevant to investors who have a low FinaMetrica risk tolerance score. In the lifetime of a portfolio there will be many more bad news stories for investors who look at their investments in a disaggregated manner compared to the ones who simply look at the overall balance.

## Financial planning perspectives

There is nothing about current events that necessarily changes future expectations. Nevertheless:

- It may be a good time to review a client's full financial plans, particularly their goals and aspirations compared to likely available resources.
- It may be a good time to rebalance the portfolio and look to acquiring underpriced assets.
- It is worth remembering that market declines often generate tax management and estate planning opportunities.
- Finally, if you and your clients have an agreed long-term asset allocation which includes an agreement of what to do in market extremes, now might be the time to re-examine it.

Whatever you do, it is not a good time to make snap decisions. The most recent falls have not been the worst in the past 40 years. Nevertheless it can take a fairly long time for the market to reach the bottom and recover but, importantly, it has done so every time.

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A UK edition of this article, *Rollercoaster Ride*, was published in FT Adviser on September 8<sup>th</sup> 2011.