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2009 share market update

Snapshot

How did this global downturn happen?

The magnitude of the fall in the share market since November 2007 has left many Australians questioning their long term investment strategy. While the last 3 weeks have seen share markets in Australia and the rest of the world rally by over 15%, investors are uncertain as to what this means going forward given the drop of around 50% in global markets between November 2007 and 2009. These are not normal sharemarket movements - falls of this magnitude occurred only twice in the last century - and astute investors are asking three important questions!

- >> How did we get to this point?
- >> Why didn't you warn me 18 months ago of this impending crisis?
- >> Where to from here?

Let's go through it step by step.

How did we get to this point?

Economists have written pages on the subject, however it comes down to a few major events:

- >> The fundamental and unavoidable truth is that the rot started in the United States.
- >> In hindsight US Federal Reserve chairman Alan Greenspan reduced interest rates by too much and for too long, following the September 11, 2001 terrorist attacks.
- >> Millions of people borrowed far too much money, and some financial institutions engaged in shameful and often predatory lending practices in what we now call the 'sub prime' lending area.
- >> Money was too easy to obtain; interest rates were too low which led to what we now call the NINJA mortgage – that is no income, no job or assets.
- >> Because these loans were sold to people who couldn't really afford a house, they came with higher interest rates – even though they were disguised by low initial rates.



- >> These mortgages were then sliced into pieces and bundled into investments – known as Residential Mortgage Backed Securities (RMBS). These were then sold to investors (mostly other banks), in and outside the United States.
- >> Investors then leveraged these funds by borrowing against them, now known as collateralized debt obligations (CDOs). These CDOs then promised high returns when on-sold to other investors.
- >> Greed from the major US banks followed shortly thereafter.
- >> Top Wall Street firms then lent heavily on the mistaken assumption that US house prices would never fall – therefore these RMBS & CDOs were seen as ‘low risk’ investments.
- >> When the owners of these mortgages defaulted, and house prices started falling, investors along with global banks were left with an asset that was worth less than the borrowed money secured by the investment.
- >> The magnitude of these losses was astronomical (over three trillion dollars) and major banks Bear Stearns and Lehman Brothers failed whilst larger global banks such as the Royal Bank of Scotland and Citibank required repeated taxpayer funded bailouts to save themselves.¹ These banks were deemed ‘too big to fail’.
- >> Banks across the world who had purchased these investment products, stopped lending to each other for fear that their counterparties had hidden toxic assets on their balance sheets.
- >> The financial system relies on a free flow of money between institutions and once banks got into trouble (or were suspected of being in trouble), no one was prepared to lend – causing the credit crunch to peak in October 2008.

- >> Share markets around the world re-acted to the loss of confidence and fear of recession, leading to sharp falls in share markets worldwide throughout 2008 and into 2009.
- >> Recessions followed in most major economies including the United States, United Kingdom, France, Germany and Japan.

Why didn't you warn me 18 months ago to sell shares or investments with share exposure?

It's fair to say that the events of the last 16 months caught virtually everyone by surprise. A small minority of economic commentators profess they saw it coming, but it's easy to say that after the event. As advisers, we look to government institutions and research organizations to provide economic guidance including the Reserve Bank of Australia (RBA), IMF, and the US Federal Reserve and 16 months ago they did not see this coming. You only have to look at the actions of the RBA to see this.

The RBA increased interest rates repeatedly throughout 2008 concerned about inflation and the Australian economy overheating. In September 2008, the RBA realised it had gone too far and slammed on the brakes with successive interest rate cuts totalling 4%. Governments and reserve banks around the world followed a similar pattern.

This raises the question: How can key government institutions be so poor at preventing serious economic shocks like the 2008 credit crisis (via better regulation or other means), while at the same time be so accomplished in medicine, engineering and telecommunications? Why can we land men on the moon with pinpoint accuracy, yet fail to steer our economy away from severe economic crisis?

Don't be mistaken, share markets are never expected to go up in a straight line every year. Like it or not, volatility is part of the deal if you own shares. This means in the short term, owning shares either directly, via a managed fund, and/or through superannuation can become an emotional and financial rollercoaster.

Snapshots

In the long term though (ie. 10 years plus), a share portfolio properly diversified has historically been a safe bet. The problem with human nature, is we tend to live our lives in days, minutes and seconds, so at the moment shares look like a terrible investment!

Where to from here?

The most common questions we hear are “when will things get better?” and “have we got to the bottom yet?” Notice that both these questions are asking for predictions about the future. It’s human nature to crave certainty. We would all like to be sure that we will have a well paying job this time next year or our kids will get good marks at school - and of course we can work hard, but we can never be 100% sure what will happen.

What we’d like to do in this article, is to stand back and review what has happened over the past 16 months and longer and take a look at history as a navigation guide looking forward. As Mark Twain once put it, “history doesn’t repeat itself, but often it rhymes”.

Human nature also means we have short memories. The Australian economy has been bounding along uneventfully for the last 17 years and many people can’t remember a serious recession. People with longer memories will know that economies move in cycles and it is ‘normal’ for share prices to move up and down.

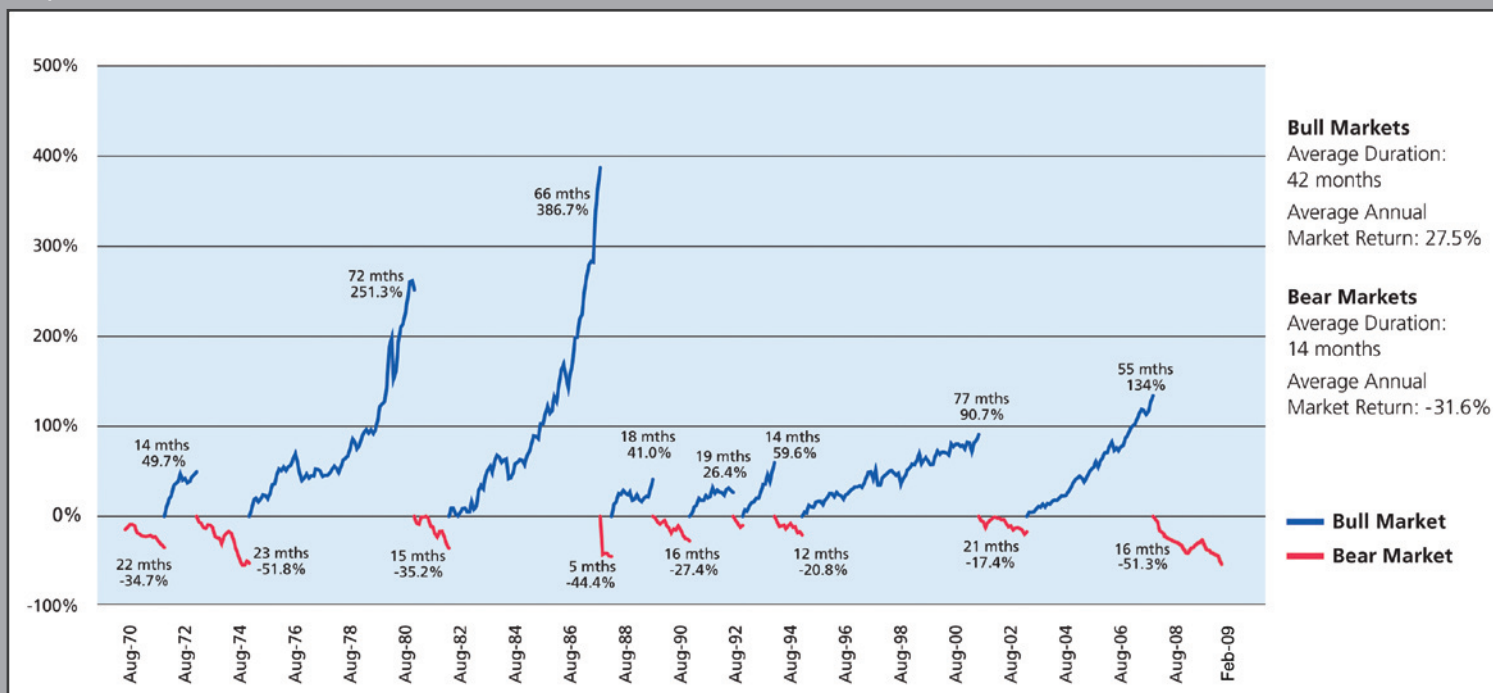
Share markets are driven by the performance of listed companies and their profitability is driven by the state of the local and world economies. When share markets are rising strongly they are called ‘bull’ markets. When they are falling they are called ‘bear’ markets.

Graph 1 (below) shows the performance of the Australian share market over the last 29 years. There have been nine bear markets (the red downward lines) of varying severity and speed. The deepest bear market was in 1973-74 when the oil price shock caused the end of the post war boom. Share prices fell 51.8% over two years.

The steepest crash was in 1987 when too much borrowing again fuelled speculation in shares and property. The share market fell 44.4% in just five months.

In comparison the current bear market has seen the share market fall approximately 51.3% over 16 months. One thing you will notice from Graph 1 is that bear markets do end, they don’t last forever. Furthermore, you will notice they were followed by strong bull markets (the blue line) with returns significantly outstripping the negative returns from the bear markets.

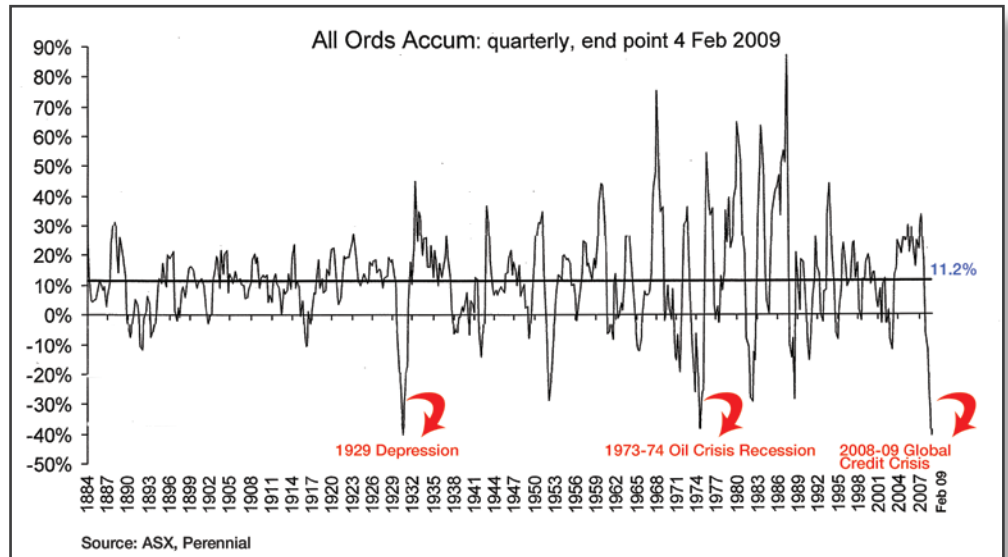
Graph 1 – Bull versus Bear Markets



Source: Datastream, Bloomberg and Zurich Investments. Adapted from The Australian 7/0/03 pp 4 using source of Clarington Fund Inc. and Yahoo Finance.



Graph 2 – Rolling 12 month returns



What does today look like in the context of history?

Graph 2 (above) takes an even longer view of the Australian share market over the last 125 years. The average return is 11.2% pa but as you can see each year, the returns vary dramatically. In some years, the returns are over 80% (as in 1986) and at other times they are close to minus 40%.

So the share market in 2008-09 is as bad as it has ever been. Only the 1929 Great Depression and the 1973-74 Oil Crisis related crash have been comparable.

How long will it last?

Here we are again trying to predict the future. Just as no one predicted this crash, no one is game to predict when the bear market will end.

Take a look at Table A (below) which looks at the ten bear markets over the last 29 years. Look for example at the “dot.com crash” in 2002-03. It took twelve months for the market to decline 22.3% and ‘bottom’. On average, these ten bear markets ‘bottomed’ or lasted 15 months and the market fell on average by 34%. You don’t want to miss the rebound however! The average 12 month return directly after the bear market was an impressive +32%. There in lies the reason many commentators recommend share investors ‘stick it out’, because when the bear market changes course, it does so unexpectedly and can offer substantial gains.

It’s important to remember that the current bear market has already lasted 16 months and the market has fallen 51.3%.

	Months to reach low	% Fall	% gain in first 12 months
Jul 1960 – Dec 1960	20	-19.6	+12
Feb 1964 – Jun 1965	16	-20.4	+9
Jan 1970 – Nov 1971	22	-39	+52
Jan 1973 – Sep 1974	20	-59.3	+51
Nov 1980 – Jul 1982	32	-40.6	+39
Sep 1987 – Nov 1987	2	-50.1	+35
Aug 1989 – Jan 1991	15	-32.4	+39
Feb 1994 – Feb 1995	12	-21.7	+25
Mar 2002 – Mar 2003	12	-22.3	+27
Average	15	-34	+32
Nov 2007 - Feb 2009	16	-51.3	?

Table A

Source: Bloomberg, AMP & Perennial

The longest bear market (1980-82) lasted 32 months, so on that basis, we are nearer to the end than the beginning.

We can be certain of one thing. The bear market will end and share prices will recover. Take a look again at Graph 1 (on page 3). The market has always recovered (see the blue upward lines) and there is no reason to think this one will be any different. In fact governments all over the world are working together to maximise the chance of a recovery sooner rather than later. This global response is unprecedented.

In Australia the government has committed \$42 billion to stimulate the economy. Significantly \$28.8 billion will be spent on 'nation building' infrastructure development. This will improve productivity and enable us to respond faster when world economies start to recover.

There are important lessons to take from history.

Lesson 1 - markets recover

In virtually all recoveries the bull market was much stronger than the bear market. Looking at Graph 1 (on page 3) for instance, the share market grew by 251.3% over the three years after the 1973-4 crash. After the dot.com crash in 2002-03, the market fell 17.4% but recovered by 134% over the next four and a half years.

Lesson 2 - markets are forward looking

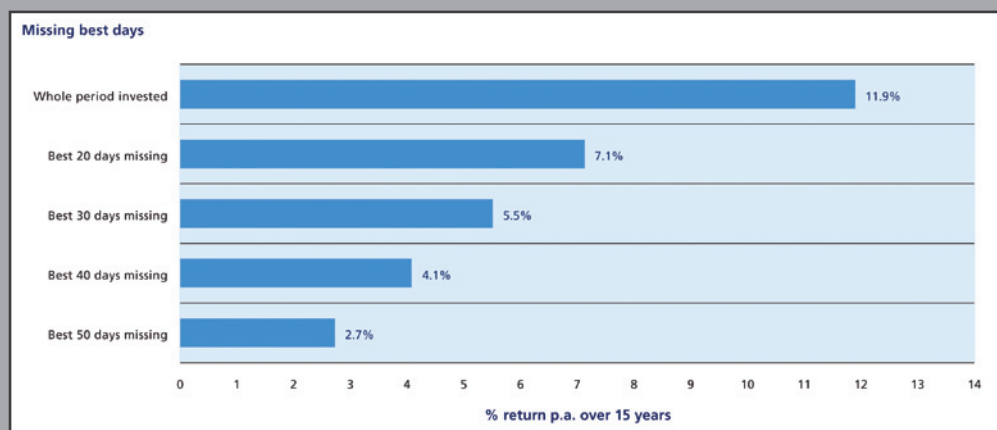
Professional share market investors assess all the current information and try to predict company performance in the future. For instance, with all the talk of a world wide recession, they may predict poorer performance by banks because of the threat of loans going bad.

If growth is slowing in China, they may predict that the demand for coal and iron ore will diminish causing commodity prices (and the share prices of resource companies) to fall. Share prices today will be based on ALL the 'bad' news currently in circulation.

The same applies when economies recover. Investors will look for 'good' news and share prices will start to recover BEFORE economies turn around. Investors need to see a few bits of good news before their confidence is restored.

It is easy to argue that the best investors "buy low and sell high". If only it were that simple. In hindsight the top and the bottom are obvious but even the best informed and most experienced investors find it impossible to consistently pick the turning points. Sometimes they get lucky and will brag about their skill. When they get it wrong, they are noticeably quiet.

Graph 3 – It's your time in the market - not timing.



Source: Zurich Investments - S&P/ASX 300, Accumulation Index, 15 years to June 2008



Lesson 3 – time in the market beats timing the market

Even worse than missing the turning points, investors who hold onto cash waiting for the share market to recover often miss the best returns.

A bull market often starts with a rush once investors begin to be more confident about the future and investors sitting on cash may miss the rebound.

You can see in Table A (on page 4) that the share market has made significant gains in the year after the end of a bear market. Using the dot.com crash again, the market fell by 22.3% in 2002-03 but bounced back by 27% in 2004.

Graph 3 (on the previous page) shows the impact of being out of the market. A person invested in the S&P/ASX 300 Accumulation Index from June 1993 to June 2008 would have earned 11.9% per annum despite having experienced some ups and downs along the way.

Now if this investor had tried to time the market and missed the best 20 days, their return would fall to 7.1% pa. Imagine that – just 20 days out of almost 5,500 days makes a 4.8% per annum return difference.

Investing in cash is seldom a good long term strategy. With interest rates coming down and likely to be even lower by the end of 2009, returns from cash investments will be very low. In fact at the moment, RBA cash rates are lower than inflation, so money in 'safe' cash investments is actually losing purchasing power.

So what do I do?

Not all investors are the same. If you are a long term investor and have sufficient income and cash for emergencies, selling shares now may not provide the best long term outcome. For instance, superannuation investors who cannot access their money for the next 10, 20 or 30 years will probably be better to stick to their long term plan and wait for the markets to recover.

Chris Caton of BT recently pointed out the current situation is like a transfer of wealth from one generation of shareholders and home owners who are selling out, to the next generation, who are taking advantage of the opportunities. In his words: "if current shareholders are also prepared to be future shareholders, then the hit to their wealth is mainly temporary".²

But if your circumstances have changed, it's important to sit down with us and discuss your options in order to make the right decision.

¹ The Age January 20th 2009

² www.prlog.org/10164936-thats-the-end-of-that.html



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