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When markets bounce back

"Be warned – when equity markets recover... emotional investors will be left with a portfolio of defensive assets and a truckload of regret."

We all know equity markets rise and fall. However the recent market correction has worn down many investors. Weary of asking – 'have we reached the bottom yet?' – investors want to know when the recovery will come. Unfortunately no one knows when markets will turn. In this edition of *Investor*, **Steve Schubert** points out that if equity markets rally (as market history would suggest), investors who give up on equities risk missing a recovery that could help them recoup some of their market losses.

The party ends

Towards the end of 2007 we witnessed one of the greatest bull markets of all time. Investors in the Australian sharemarket had been riding a euphoric wave of double-digit equity market returns over the preceding five-year period, as can be seen in the table at the top of the next page. Then 2008 arrived and the party was over.

In the last few years, many 'emotional investors' who traditionally invested in more defensive assets (such as bonds and cash), transferred money over to equities, blindly attracted to the apparent returns without considering the associated risks. When equity markets collapsed this year, these emotional investors started to realise that markets could go down as well as up.

Steve Schubert
Director, Superannuation
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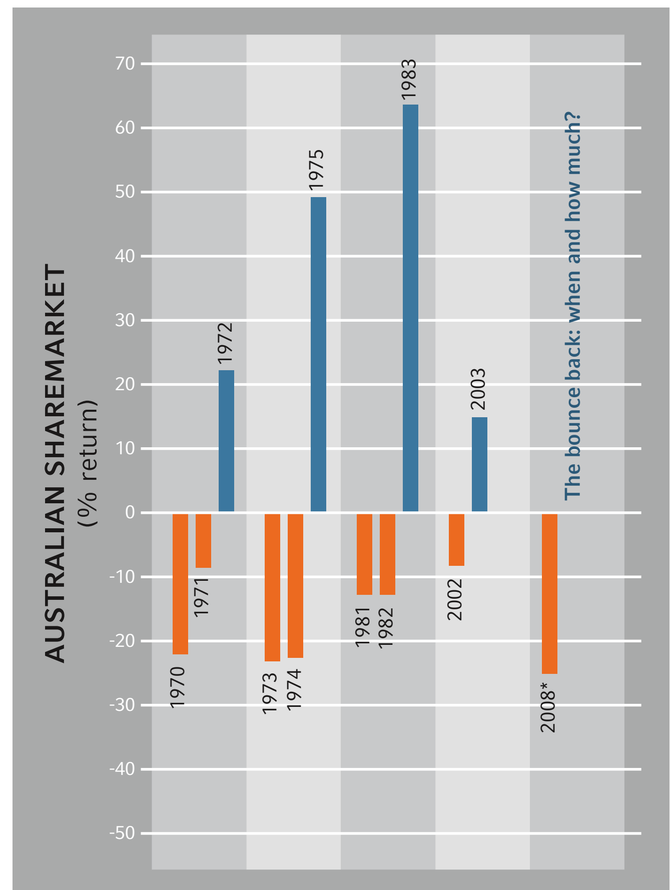


Similarly, over-attention to risk during the current market downturn has focused investor attention on minimising losses, rather than waiting to participate in the recovery. As a result, 'emotional investors' have oversold equities and transferred the proceeds into bonds and cash.

Many investors have also held back from investing in equity markets in recent months, due mainly to the uncertainty and a seemingly never ending run of negative news of corporate failures and bailouts.

Be warned – when equity markets recover, these emotional investors will be left with a portfolio of defensive assets, and a truckload of regret.

Although the current market volatility – triggered by the US housing slump and subprime mortgage crisis – has been a painful experience, investors can take some comfort in putting the recent downturn into perspective. If we step back and look at the performance of the Australian market over the past five or six years, it is easy to appreciate the value of long-term investing and quite clear that there will be another party. We just don't know when.

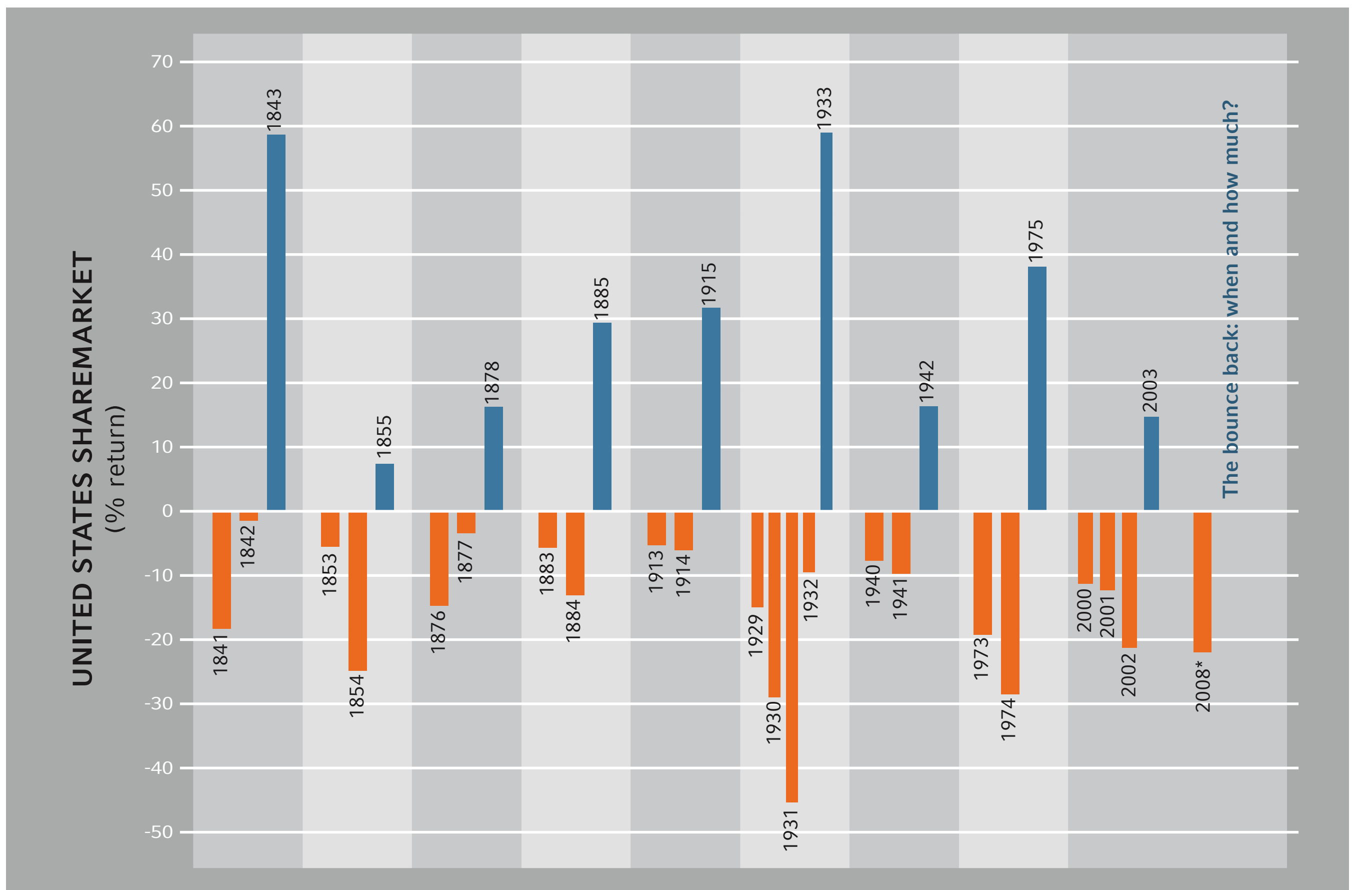
Year	Return of Australian Equities*
2003	15.0%
2004	27.9%
2005	22.5%
2006	24.5%
2007	16.2%
2008 (to 30 Sept)	-25.1%

S&P/ASX 300 Accumulation Index

In 1983 the market bounced 66.8%

The current bear market's intensity has been compared to the Great Depression and the bear market of 1973-1974. The deep bear market of 1973-1974 created many jumpy equity investors. However, those who maintained equity positions were well rewarded in the second half of 1974 and the first quarter of 1975.

The charts on pages one and two illustrate this fact. They show different time periods where US and Australian equity markets recorded strong negative returns. As you can see, periods where there are heavy losses on the markets are generally always followed by significant bounce backs.



Markets can't go down forever. Although sometimes, in the middle of a strong downturn, it is hard to believe that markets will one day recover. While nobody can accurately predict when the bottom of this trough will be reached – or indeed if it has already – everybody knows that it will (sooner or later) arrive.

And when it does, it will pay to be invested. Some of the highest returns are experienced suddenly in an oversold, overshot market.

"Some of the highest returns are experienced suddenly in an oversold, overshot market."

Give it some thought: as shown in the chart on page 1, the Australian sharemarket experienced consecutive negative returns in 1981 and 1982. However, in 1983, the market bounced back in a big way climbing 66.8%. In 2003 we also saw evidence of this bounce back phenomenon in action with the Australian market climbing 19% and the US sharemarket rallying 26% from their lows in March 2003.

While it may be tempting to simply convert equities into cash and bonds and watch from the sidelines, history tells us that investors selling to cash during falling markets can expect to see significant underperformance when equity markets return to health.

Patience and discipline are rewarded?

In extreme market conditions such as these, it is easy to let emotions override discipline. Investors who tilt their portfolios to favour one asset over another, such as bonds over equities, are attempting to time the market and adding risk to their portfolios.

Investors often believe that there is value in action. To sit back and watch investments post negative returns is simply unbearable for many. The truth is – there may be more value in 'inaction' for the smart and disciplined long-term investor.

It is important to understand the role that investor sentiment and emotion plays in the cyclical nature of equity markets. Experience tells us that decisions made about money under highly emotional circumstances rarely turn out to be good ones.

Investor sentiment in extreme market conditions is dangerous in that it often turns out to be 'self fulfilling'. This means that during a strong market upswing (rising equity prices), investors will buy 'so as not to be left out of the gains'. Conversely, during a strong downswing (falling equity prices), investors will sell 'so as not to be left wearing the losses'.

The reality is this sentiment works against the oldest investment principal in the book: 'buy low and sell high'. While extended bear markets inevitably induce fear in investors, professionals and individuals alike, a disciplined approach can help minimise losses during the downswing and ensure readiness for the upswing.

To help you manage and protect your investments during this volatile period, Russell Investments have put together ***Your toolkit for financial security in volatile markets.*** It is available on **www.russell.com.au** and contains some helpful information so that you might gain a better understanding of market cycles – and remind yourself about the benefits of staying focused on your long-term financial goals.

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