

Should you reduce risk in bull markets?

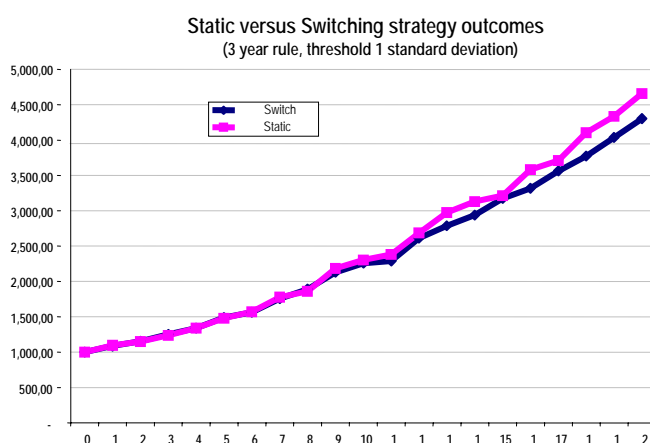
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Investors flood into share and property markets during booms. People are often happy to commit their savings and to borrow heavily so that they will not be left behind by the lucky ones who got in early. But, as experienced investors know, this is typically the worst time to put your money into markets. Numerous studies have shown that chasing returns is generally a sure way of losing money. You can't buy the returns that have already occurred.

A more sophisticated approach would be to swim against the tide by moving out of markets after periods of strong returns. The logic here is that if markets mean revert over time, moving out of markets after periods of strong returns will result in less pain when the anticipated fall occurs. Could this be a clever strategy to follow?

We tested this strategy by applying simple switching rules to market returns from 1900 to 2005. The initial switching rule that we applied was whether it would have added value to move from a 100% growth portfolio to a 70% growth/30% defensive portfolio after any 3 year period when the cumulative return was more than 1 standard deviation above the median return over the full 105 years of data. Under this switching rule the strategy was then be switched back to the 100% growth portfolio when the 3 year cumulative return fell to below the 1 standard deviation mark.

We tested how well this switching rule would have worked over the 85 individual (though overlapping) 20 year periods in the 105 years of data. The following graph shows how the median performance of \$1m invested according to the simple switching rule compares to that of a static strategy where a 100% growth assets portfolio was held over the full 20 year period.

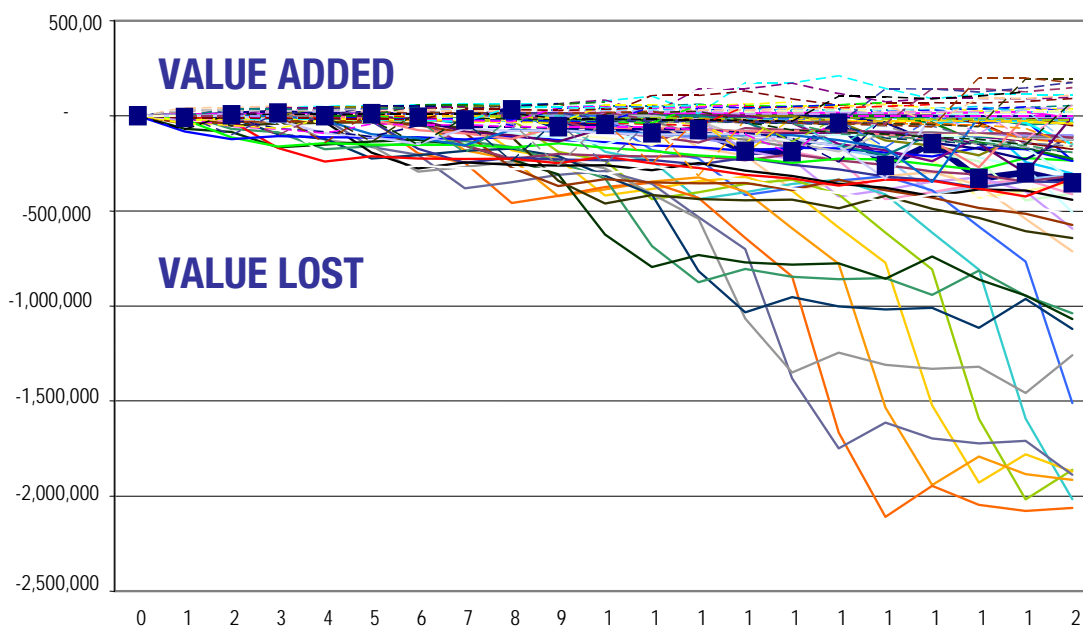


Source: Calculated using data from DMS Data Module offered through the Ibbotson Associates' software program EnCorr. ¹

¹ Source: Calculated by MLC Investment Management using data presented in DMS Data Module offered through the Ibbotson Associates' software program EnCorr. Based on copyrighted books by Dimson, Marsh, and Staunton, Triumph of the Optimists, Princeton

The graph shows that sticking with the same strategy and riding out the ups and downs did better, on average, than reducing risk after good returns. The next graph shows the gains and losses compared with the static strategy for the range of 85 individual 20 year portfolios.

Switching versus Static strategy: difference switching makes to real value of portfolio
(Starting value of portfolio \$1m, 3 year rule, 1 std deviation threshold)



Source: Calculated using data from DMS Data Module offered through the Ibbotson Associates' software program EnCorr. ¹

While over some 20 year periods following this simple contrarian approach would have added value, over most periods it would have lost value. Not only did switching lose value much more often than it added value, the amount that was lost was, on average, 6 times as much as was gained on the infrequent occasions when switching added value.

To test how robust these findings were, we varied the threshold for switching up and down. Interestingly, we could find no trigger level for switching which over the full period would have added value.

We also examined whether changing the time period from cumulative 3 year returns would have altered the result. What we found was that the shorter the time period to which the return threshold was applied, the greater the value lost. It was not until the time period was extended to 20 years that value was added from switching. With this result, however, we should display more caution because there are so few distinct 20 year time periods in this data set.

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In conclusion, historical evidence indicates that a strategy of reducing risk on the basis of strong past performance has typically been a losing strategy. This reinforces our view that using past performance as an indicator of future performance is not reliable. Swings in investor sentiment are a key driver of market performance over short periods and cannot be reliably forecast. Although intuitively appealing, simple market timing approaches based on past performance do not work.