An Overview of Investing in Volatile Markets

There has been a lot in the media recently about investment market volatility – particularly about the causes, and likely impact of the US sub-prime crisis. Not surprisingly, many investors have asked whether this latest volatility should have an impact on their investment strategy. While it is smart to reassess your investment strategy in line with changes in your personal circumstances, experience has shown investors that stick to their investment strategy are more likely to achieve better returns in the long term.

For example, DALBAR (a Boston based financial research organisation) in their study titled “Quantitative Analysis of Investor Behaviour (2007)” found that over the 20 years to the end of 2006, the average US investor in equity mutual funds had received a return of only 4.3% per annum (p.a.), compared to the S&P500 return over the same period of 11.8% p.a. They concluded that investors’ behaviour cost them around 7.5% p.a. over the 20 year period – or on a $100,000 investment that’s the difference between a final outcome of $232,106 rather than $930,756 – or a cost of almost $700,000.

Generally, investors are therefore best placed by staying put during any periods of market volatility and focussing on the long-term outcomes.

To help ease your mind when investing during what may appear to be volatile markets, we have compiled a number of investment insights to remind you why we invest in risky assets and how to avoid making investment errors. We also explain how MLC’s portfolios are constructed to help you manage any volatility.

Helpful insights to investing in volatile times

To keep you focused on your goals during volatile times, keep in mind the following seven insights:

1. Risk and return are related
2. What goes up must come down, occasionally
3. Diversification reduces volatility and can enhance returns
4. It’s time in the market, not timing the market that matters
5. Chasing performance can cost you money
6. Patience is a virtue
7. Talk to your financial planner
1. Risk and Return are Related

History has shown that there is a strong relationship between risk and return – the higher the expected level of return, the higher expected risk (or volatility) you need to be willing to accept. Industry experts believe that there is no reason why this relationship won’t continue in the future.

Graph 1 below represents MLC Investment Management’s view on the relative risk and return for the different asset classes. It highlights that to achieve higher returns, investors have to be willing to tolerate higher risk (or volatility).

This relationship can be seen historically, and is expected to continue in the future. However, over the last few years, we have seen a short-term occurrence where the volatility in financial assets has been considerably lower than historic averages.

For example, the volatility of the Australian equities market\(^1\) over the last 3 years to end of December 2007 has ranged from 6-10\% p.a., compared with its long-term average since 1980 of just over 15\% p.a.

The recent market volatility is therefore not unusual, but merely takes us back closer to long-term averages. Investors should expect that financial markets will have periods of both good and poor returns over time. Equities are still relevant for investors’ portfolios, in order to achieve a rate of return that allows them to achieve their financial goals.

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\(^1\) Based on standard deviation of monthly returns in the All Ordinaries Accumulation Index from 1980-2004 and the S&P/ASX 300 Accumulation Index since 2004.
2. What goes up must come down, occasionally

As an investor reading recent financial headlines, you could be forgiven for thinking that the current investment market volatility is new and extraordinary. However, the media is more interested in selling their headlines, so they make the most of these kinds of situations, rather than reporting the reality. The reality is that financial markets rise and fall as part of normal and expected market behaviour worldwide.

Resilient investors know that despite the inevitable ups and downs of sharemarkets, staying invested and maintaining a long-term strategy generally gives them a greater chance of reaching their financial goals.

As you can see in Graph 2 below, sharemarkets generally reflect the broader economic environment so you must expect some years of low or negative returns during poor economic conditions – such as the “Recession we had to have” in 1990-1992 (marked by a bar). But the reality is that in the past, markets have bounced back and eventually returned to and surpassed previous levels.

Graph 2: Australian Shares – Value of $10,000 invested (Jun 1985 – Sep 2008)

Over the 28 year period (1980-2008), there have been 36 official corrections (i.e. where the market has fallen by 10%) in the Australian market (and even since September 11, 2001, we have had 9 corrections including the last correction in September 08). However, most of those corrections are now barely visible on the graph.

Most importantly, reacting to these corrections is often a dangerous investment strategy, because it often means you miss out on the subsequent rebound – the average 12 month return after a 10% correction has occurred has been 18.3%. Missing this kind of return would have a dramatic impact on your overall wealth.

And more significantly, missing just a few of the best days in the market can have a significant impact on your portfolio (see Graph 4). It’s time in the market, not timing the market that matters.

However, the time taken for the market to recover to a new high varies; it may take a few days, months or years. Since 1980, the time taken to achieve a new all-time market high has varied from 58 to 1,186 days.

This shows that knowing when the market will recover is impossible, so you need to be prepared to invest for the long-term, and ride out any periods of uncertainty to reap the benefits of investing in growth assets.
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3. Diversification reduces volatility and can enhance returns

The aim of diversification is to ensure your investments don’t all move in the same direction at the same time, without compromising your long-term returns. The differing returns of each investment tend to offset each other which helps to smooth your overall return.

Graph 3 below shows the 1 year returns for a range of asset classes and an equally weighted diversified portfolio since 1981. Each point on the line represents the 1 year return for the 12 months prior to that time.

The graph shows that while asset classes produce different returns over time due to different market conditions, a portfolio with some exposure to each of the assets (the bold line) will have relatively more consistent returns and should have few that are negative. So why are more consistent (or smoother) returns important? Smoother returns can actually enhance your outcome when investing.

For example, the following table shows how portfolios with the same average level of returns can deliver very different total returns to investors...

<table>
<thead>
<tr>
<th>Year</th>
<th>Consistent Investment</th>
<th>Volatile Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>8% $108,000</td>
<td>30% $130,000</td>
</tr>
<tr>
<td>2</td>
<td>8% $116,640</td>
<td>-25% $97,500</td>
</tr>
<tr>
<td>3</td>
<td>8% $125,971</td>
<td>30% $126,750</td>
</tr>
<tr>
<td>4</td>
<td>8% $136,049</td>
<td>20% $152,100</td>
</tr>
<tr>
<td>5</td>
<td>8% $146,933</td>
<td>-15% $129,285</td>
</tr>
<tr>
<td>Average</td>
<td>8%</td>
<td>8%</td>
</tr>
</tbody>
</table>

While this is an extreme example, you can see that while the two investments have the same average return, they have a very different overall investment outcome, with the consistent investment providing a better overall investment outcome.

As outlined above, not only can diversification provide smoother investment returns (by reducing the impact that any one investment or asset class has on your portfolio), it can also result in a better final outcome for your portfolio due to the benefit of smoother returns.

Graph 3: Diversification reduces volatility – rolling 1 year returns (assumes income is reinvested)

4. It's time in the market, not timing the market, that matters

Inexperienced investors often respond to market events, and attempt to reduce the volatility of their investment portfolio by selling once markets fall and buying in when they are rising. However, investment markets are unpredictable, and attempting to identify the best time to buy and sell is impossible to do well consistently. Attempting to time the market in this way is therefore better described as ‘speculating’ rather than investing.

While intending to improve their returns, speculators are usually destroying their wealth as they tend to sell after markets have already fallen to some extent and buy back in after markets have risen. As markets tend to rise in accelerated bursts, speculators often miss out on many of the days the market produces the highest returns.

For example, the following graph (which excludes dividends) shows that missing out on just the 10 best days in the Australian sharemarket since 1980 would have been very costly to your wealth. Missing just those 10 best days would have reduced your return from 8.2% p.a to 6.2% p.a, and cost you almost $35,500 on a $10,000 investment in 1979 (excluding dividends).

While it may sound unlikely to miss all of the 10 best days, it should be remembered that many of the best days have occurred just after a significant fall – for example, five of the Top 10 single day rises occurred just after the 1987 stock market crash.

Market timing is not a strategy which can be relied on to grow your wealth and the longer you’re out of the market the worse off you may be. During volatile times, it is important to stick to your long-term investment strategy.
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5. Chasing performance can cost you money

Similar to “speculating” (as described above), studies have shown some investors also move into another asset class, in an attempt to benefit from recent strong returns. Unfortunately, as these investors chop and change their investment strategy to chase stronger returns, many move to chase investments that are already close to their peak. So these investors usually miss out on the best performing days.

As shown in the case study below in Graph 5, maintaining a diversified portfolio exposed to many asset classes can produce a better long-term return than chasing last year’s best performing asset class.

Say you invested $100,000 over the last 26 years:

- If you chased the best performing asset class from the previous year, your investment today would be valued at $2,029,968. A compound return of 12.3% p.a.
- But if you stay invested in a balanced portfolio, your investment would now be worth $2,518,742. A compound return of 13.2% p.a.

And that’s before you take into account the cost and capital gains tax associated with switching assets classes every year. This shows that switching course and trying to catch the best performing asset class can be very costly to your investment outcome.

Graph 5:

Value of $100,000 since December 1980

Data: Australian Shares based on the S&P/ASX All Ordinaries Accumulation Index, Global Shares based on the MSCI World Gross Accumulation Index (US$), Australian Bonds based on the Commonwealth Bank Bond Accumulation Index, Listed Property Securities based on the S&P/ASX200 Property Accumulation Index (Listed Property Trust Accumulation Index prior to July 2000), and Cash based on UBS Werksbank Australia Bank Bill Index (RBA 13 Week Treasury Notes prior to April 1987)

The Strategic Balanced Portfolio is based on the average asset allocation of Balanced Funds within the Mercers Wholesale Performance Analytics toolkit as at 31 December 2005 (Australian Shares 37%, Global Shares 24%, Australian Bonds 31%, Listed Property Securities 8% and Cash 0%)
6. Patience is a virtue
When you measure your returns over a short period of time, say a few months or even a year, they will appear to fluctuate quite a lot. However, the longer the period of time you consider, the less your returns appear to move around. This is simply because much of the volatility declines (as the different returns offset one another) until eventually there is little volatility left.
To illustrate, Graph 6 below shows the range of returns in Australian shares over different time periods since 1980 and median i.e. the middle point of the range of returns.
Although you will still need mental preparedness for the difficult times, as it’s not always easy to ignore what is happening to your investment each day, month or year, you should understand that you will face volatility in the short term and monitor your progress against your long-term goals.

7. Talk to a financial planner
It is important to realise that when investing, we are looking to grow our real wealth to achieve our goals and objectives. Studies have shown that the most important factor to your investment portfolio return is the combination of asset classes you select.
Your financial planner is able to help you select the most appropriate investment portfolio for your objectives, needs and current financial circumstances. Your planner knows your individual circumstances and is in the best position to give you personalised advice. They will ensure that your portfolio is built with the key investment fundamentals in mind:
- Long-term investing
- Diversification
- Risk and return

Graph 6 – Range of Returns of Australian Shares since 1980

Source: S&P/ASX300 Accumulation Index to September 2008
It is also worthwhile remembering that there’s a saying that in the darkest night it’s easy to see the brightest star. And that’s also true of investing. When sharemarkets are out of favour, savvy investors often see the potential to buy while prices are low. Depending on your circumstances and advice from your financial planner, low prices may represent an opportune time to invest.

If you’re in any doubt about your investment strategy, or you see an opportunity to take advantage of the current market conditions, the best person to seek advice from is your financial planner.

Above all, keep in mind the fundamentals of investing and you stand to become a successful investor.
MLC’s Multi-Manager Investment Process – discipline in uncertain times

MLC realised over 20 years ago that investing is difficult, and investors can (and often do) make investment decisions that destroy their wealth. To help investors grow their wealth, MLC pioneered multi-manager investing in Australia over 20 years ago.

While markets have been up and down many times over this period, MLC has continued to generate wealth for long-term investors. The main features of MLC’s Multi-Manager Investment Process, which provide protection against market volatility, are:

- **Diversification** – Investing in assets that perform differently to each other through time will help lower the volatility of your overall returns. MLC’s portfolios are extremely well diversified across investment strategies, asset classes, investment managers and securities to provide reliable performance over different economic and market environments. For example, as at 30 September 2008, the MLC Horizon 4 – Balanced Portfolio had 28 investments managers, in 8 asset classes, invested in more than 2,000 securities spread over 60 industries and 40 countries.

- **Long-Term Strategic Approach** – MLC is disciplined in applying a long-term view in its decision making process so it avoids reacting to short-term movements in the market which are usually wealth destroying. MLC sets a long-term target allocation to each asset class which is rigorously stress-tested, aiming to provide reliable performance over different economic and market environments. MLC’s long-term approach means it keeps your portfolio within the target weightings through a process of rebalancing. This process means MLC tends to buy assets when they are priced low and sell when they are high.

- **Hiring Multiple Excellent Investment Managers** - As markets move in cycles, certain market conditions will suit certain types of managers. Every investment manager has periods where their investment process is not favoured by prevailing economic and market conditions. Therefore, an investment manager’s performance will fluctuate over time. As a result, it is not enough to find what you believe to be the best manager, as this will result in significant volatility of returns within that asset class. Instead, MLC combines managers with different, but complementary, insights into investment markets. And as long as you continue to have the ‘best’ investment managers, combining several different managers will not dilute long-term performance.

Diversifying across a wide range of the world’s best investment managers – and implementing the strategy efficiently – takes significant scale and resources. MLC’s size and expertise not only allows it to research and employ a large number of managers, it helps reduce the associated costs and inefficiencies that would otherwise diminish potential returns.

If you have any queries about how MLC’s portfolios can help you achieve your goals, please contact your financial planner today.
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