MORNINGSTAR

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Getting the edge with managed funds
Four lessons from the market

Since 2000, investment markets have weathered a variety of conditions - from volatility to stability, then recovery and volatility again. These changes have left many people wondering what the best way is to approach their investments.

Don't panic

Many people may be tempted to move their money out of the share market during times of volatility or weakness. But it's important to remember that markets move in cycles. Peaks and troughs are an intrinsic part of investing. While the cycle is unpredictable, history has shown us that recoveries always follow downturns, and vice versa. If you move out of the market, then you won't be there for the recovery, which can sometimes arrive unexpectedly and take off quickly.

The 1990s provided a period of stability and sustainable growth for investors, yet by the end of the decade, a series of events that were largely unpredictable had taken their toll on investment markets. The 'tech-crash', September 11, corporate corruption, the global economic slowdown, and the war in Iraq all contributed to volatile conditions in the markets.

From 2003 the global economy started its recovery and conditions stabilised, giving markets the opportunity to respond favourably. At the beginning of 2007 the ASX was 83.1% higher than it was at its highest point in the 1990s (source: Reserve Bank of Australia).

By the middle of 2007 however, concerns over sub prime lending in the US had sent shock waves through stock markets across the world. The Australian share market lost nearly 15 per cent between the high reached in July and low reached in mid-August, but by the end of August had bounced back to pre July levels. Many commentators are now calling that period of volatility a "market correction".

Throughout any market cycle, those people who hold their nerve, who remain focused on their long term goals and resist making snap decisions, are likely to be the winners.

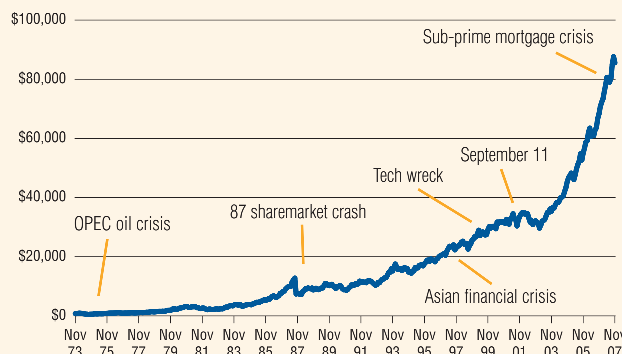
Lesson 1: Markets move in cycles

Investment markets move in cycles, and it is impossible to predict when a market will rise or fall.

However, by looking at the past we can observe how markets usually perform, and that can help us in the future to put market movements in perspective.

Downturns and recoveries

Growth of $1,000 in Australian shares since 1973 [1]



- The 1974 OPEC oil crisis sparked a 50% drop in the market. Four years later, the market had recovered its value, and continued to climb higher for the next two years.
- On 20 October 1987, the All Ordinaries index fell 25% in one day and continued to lose ground over the next five months. It took six years for the market to regain its value, but since then the All Ordinaries has risen more than 200%.
- In 1997, the Asian crisis resulted in a 10% slide on the market in a single month. One year later the market returned to its original value and gained an additional 10% the following year.
- The 'tech wreck' began in March 2000. The Australian market held up relatively well, but US shares plummeted. In the wake of the tech wreck, the NASDAQ index slumped 64%.
- In late 2001, the continued fallout of the tech wreck, signs of a world economic slowdown, corporate scandals and September 11 sparked a 12% slide on the All Ordinaries index over a 3-month period.
- In the wake of the sub-prime mortgage crisis in the US, the S&P/ASX 200 index of the Australian sharemarket fell by a combined total of 2.7% over June and July of 2007. However, by the end of September 2007 the sharemarket had recovered, rising by a total of 6.9% during August and September.

[1] Based on the All Ordinaries Accumulation Index.

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Markets always recover

One thing we know from looking at the long-term performance of the share market is that, despite short-term volatility, the market always recovers.

Even after the crash of 1929 the share market eventually recovered, although it did take more than 10 years. The good news is that since the 1960s, the recovery period has been shorter, typically less than 5 years.

Avoid bubbles

Speculative investment bubbles have been around for as long as markets themselves, pushing the prices up, normally in the short term.

A bubble occurs when investors come to believe that the investment environment has changed in some unique way, and that prices will never go down. Remember markets are unpredictable - those investing for a 'quick win' at the height of the tech bubble paid a premium for their assets and would not have foreseen the tech crash that followed.

1635: tulips

In the late 16th century, the Dutch came to celebrate the beauty of the flower from the then-rare tulip bulb. By 1635, two tulip bulbs could be exchanged for a quality home. Investors came from all over the world and from all walks of life to take part in the tulip-buying frenzy. The bubble burst when buyers defaulted on purchase agreements and people lost interest in the flower.

1969: nickel

In 1969 Poseidon, a small mining company, discovered a vast nickel reserve in Western Australia. The discovery pushed the company's share price from $1 to a February 1970 peak of $280. By December 1970, Poseidon's share price had plunged back to $39 as investors placed a more realistic valuation on the reserve. The company went into receivership in 1976.

2000: technology

The belief that the internet had economic ramifications similar to those of the industrial revolution spawned a share-buying frenzy. Investors drove technology share prices higher, despite the companies having little prospect of turning a profit. The NASDAQ soared higher year after year, but fell 64% in the year after peaking. Investors acknowledged that the new technology didn't always translate into revenue, let alone a profit.

Lesson 2: Diversification reduces risk

It is impossible to predict market movements accurately. Attempting to do so is little more than speculation.

However, you can reduce the impact of market movements by diversifying your portfolio.

A diversified portfolio is spread across a number of different asset types. Diversifying prevents the value of your portfolio from being dependent on the performance of a single asset type. A fall in the value of one investment may be offset by gains in the value of another.

Ways to diversify

Type of diversification	Achieved by
Across asset classes	Including a range of asset classes in your portfolio. For example, your investment portfolio may contain shares, property, fixed interest and some gold bullion.
Within an asset class	Within Australian Shares for example, you may buy shares in companies that operate in different industries, such as mining, retail, banking and biotechnology.
Across countries	Reducing your exposure to a single country or region. You may wish to have investments in Australia, the US, Europe and China.

Managed funds provide an easy route to diversification. Through a single managed fund it's possible to diversify across asset class, company, industry, sector, country and even fund manager.

Diversification means you don't need to pick the performers each year

Financial year returns for major asset classes

Year End	Cash	AUS Bonds	Property Trusts	AUS Equity	International Equities
30-Jun-97	6.77%	16.76%	29.29%	26.56%	29.11%
30-Jun-98	5.11%	10.88%	10.21%	1.64%	42.68%
30-Jun-99	5.04%	3.28%	3.11%	15.34%	8.54%
30-Jun-00	5.58%	6.17%	16.62%	15.06%	24.17%
30-Jun-01	6.08%	7.42%	13.90%	9.11%	**-5.67%**
30-Jun-02	4.66%	6.21%	14.85%	**-4.54%**	**-23.21%**
30-Jun-03	4.97%	9.78%	12.15%	**-1.61%**	**-18.15%**
30-Jun-04	5.30%	2.33%	17.24%	21.73%	19.90%
30-Jun-05	5.66%	7.93%	18.10%	26.03%	0.53%
30-Jun-06	5.76%	3.41%	18.05%	24.02%	20.44%
30-Jun-07	6.42%	3.99%	25.87%	29.21%	8.27%

Source: Cash: UBS Warburg Bank Bill Index, Australian 90 Day Bank Accepted Bill; Australian Fixed Interest: UBS Warburg Composite Bond Index; Property: S&P/ASX 200 Property Trusts Accum Index; Australian Shares: S&P/ASX 300 Accumulation Index; International Shares: MSCI World ex Aust. Acc Index with Gross Div. reinvested (A$)

The table shows how returns vary widely between asset classes, and within a single asset class. You will also notice that the asset classes with the greatest positive returns are also the ones with the larger negative returns.

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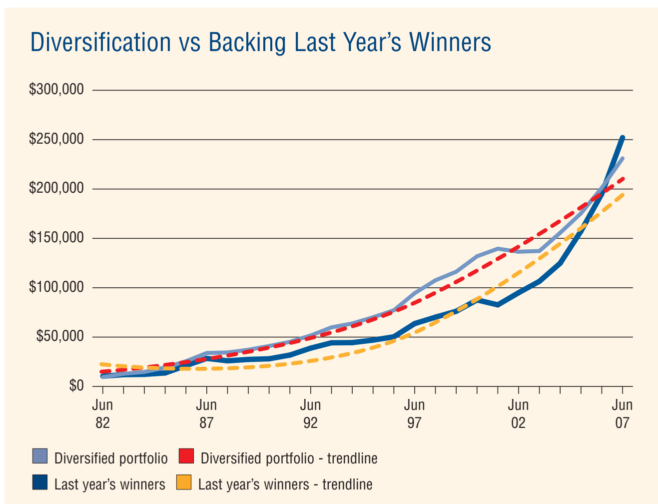
In 1999, at the peak of the technology share boom, returns varied widely. Australian shares generated a return of over 15% - particularly impressive when you consider that the gains came at the end of a nine-year run which saw the market surge 143%. In the stampede to invest in shares, the usual safe havens were overlooked. Bonds and property trusts delivered returns of only 3% each.

But the following year saw the beginning of the tech crash. Investor sentiment had changed. Returns for Australian shares were down at the end of 1999 as investors bailed out of the asset class. The bond market returned 6% in 2000 and property trusts 16%, as investors sought a safe haven for their investments.

Diversification vs Backing Last Year's Winners

Whether or not a portfolio is diversified will tend to have a significant impact on the long-term return of the investments. While it's tempting to invest in the previous year's best performing asset class, investing in a portfolio diversified across the five asset classes is likely to be more advantageous in the long run.

A diversified portfolio tends to be more stable than a portfolio concentrated in one asset class, delivering lower volatility and fewer years of negative returns. While a diversified portfolio may miss out on some of the large gains that single asset class portfolios make in some years, they also avoid the deep losses.



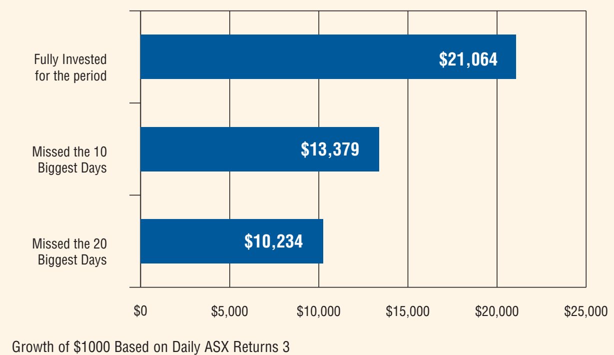
Source: Morningstar

The above chart shows that picking last year's winners has only outperformed other investment strategies in the past few years, due to the Australian share market providing consecutive years of above average performance for particular asset classes. Over the longer term, however, the diversified portfolio approach has provided more consistent, less volatile returns. This is demonstrated by the trendlines for both approaches. The fact that the trendline for the diversified approach is higher than the trendline for last year's winners at the end of the period suggests that this approach will be more fruitful over time. While backing last year's winners may offer the opportunity to make some good short term gains, it equally exposes your investment to the possibility of large future losses. History shows us that attempting to 'time the market' to participate in the upswings and to avoid the downswings in an asset class is a very difficult exercise given the unpredictable nature of market movements.

Lesson 3: 'Time-in' not 'timing'

Patience is its own reward. But patience also rewards investors.

Most of the long-term gains on equity markets are made or lost in just a few trading days each year. Take away those 'big' days and returns are more like what you would expect from a defensive investment. Investors who lose patience and get out of the market run the risk of being absent when significant gains are made.



Source: Morningstar. Based on the All Ordinaries Accumulation Index

If you had invested $1,000 in Australian shares in 1983, 24 years later it would have grown to $21,064 (making an annualised return of 16.5%). If you had invested the same amount over the same period except for the 10 biggest days in the market, it would have grown to $13,379 (an annualised return of 13.8%) and if you missed the 20 biggest days you would have just $10,234 (an annualised return of 12.3%).

Markets are unpredictable, so picking those 'big' days is impossible. Staying invested means you capture the full benefits of the share market. Your returns might be down one month, but by withdrawing from the market you run the risk of missing out on the recovery.

Who should take advantage of shares?

Generally investors with a long time horizon, who do not need to access their money for more than 5 years, can afford to take on more risk because they have more time to ride out the fluctuations on the market. However, if you intend to be in the market for less than 5 years, you might consider focusing on the less volatile asset classes such as cash and bonds.

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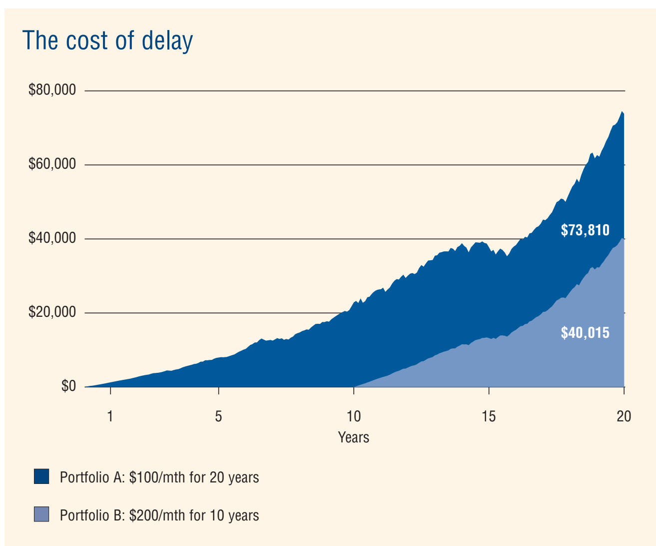
Lesson 4: Start early, save regularly

You don't need a lot of money to begin investing. By making small regular contributions over time, you might be surprised by how quickly your investments accumulate.

And investing the same dollar amount at regular intervals can help smooth out the ups and downs of markets. Investing this way means you purchase more shares or units when prices are low and fewer when prices are high.

It's important to start saving as soon as you can. The longer your money is invested the more you can take advantage of compound interest.



Source: Morningstar. Investment returns based on the Morningstar Multisector Trusts Growth index

The above chart shows how substantial a difference investing early can make. It compares the final size of the investment pools of two investors: one (portfolio A) who invests $100 each month over a 20-year period starting in July 1987; and another investor (portfolio B) who starts 10 years later in 1997 but tries to catch up by investing $200 per month for 10 years.

Both invest a total of $24,000 but because the first investor started earlier they have over $33,000 more than the later investor after 20 years.

Let's recap

- **Lesson 1:** Markets move in cycles. They go down, but history has shown us that they always recover. (Similarly, markets that rise excessively will eventually come crashing down, so beware of buying into investment bubbles.) The best approach is to accept market volatility, stick to your strategy and don't panic. By withdrawing from the market you could be robbing yourself of the most valuable gains.
- **Lesson 2:** Diversification reduces risk. Because it's impossible to predict market movements, one way to manage market risk is to maintain a diversified portfolio. Spreading your investments across a range of carefully diversified assets, will minimise the risk and smooth your returns. Your financial planner can help you learn about funds that will help to diversify your portfolio.
- **Lesson 3:** 'Time-in' not 'timing'. Be patient, especially if you are investing for the long term. When things look bleak it's important to keep your goals in focus. Getting out of the market could mean you miss the rebound and the returns that go with them.
- **Lesson 4:** Start early, save regularly. The sooner you start investing and the more often you do it, the better. Setting up a regular savings plan takes the guess work out of trying to find the right time to make an investment. Starting now will give your money time to grow through the power of compounding.

Of course, every investor has a different set of circumstances and objectives. If you are wondering how to best apply these lessons to your situation a financial planner can give you advice.

To find out more about the role of financial planners, and how to tell if you're getting good advice, please go to: www.goodadvice.com.au

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