AON

Russell Investments

Insights

Tools for sound decision making

August 2008

This issue covers:

How you can deal with volatility; and why it shouldn't distract long term investors.

Five principles for your successful investing:

1. **Courage –** Investing in shares is risky, but it's a calculated risk
2. **Honesty –** Be honest with yourself about how much you really know
3. **Detachment –** When invested in a balanced portfolio, it never hurts to read the headlines
4. **Discipline –** Don't let emotion rule your investment strategy
5. **Commitment –** Keep your eye on the prize and ignore short-term market events

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Synopsis

Markets have taken Australian investors on a wild ride in recent times. The old adage "what goes up must come down" could probably be updated. These days, what goes up not only comes down, but also goes back up and comes back down yet again.

It's called market volatility, and more often than not, how we react to volatility can determine whether or not we make a profit. In this edition of Insights, we explain that volatility is not the concern of the long term investor, and gives you the tools you need to help get you through the ups and downs.

Volatility is not the long-term investor's concern

Volatility has been present in our markets before, but recently it seems like we have been in a period of increased turbulence. Chart 1 shows that we are currently experiencing a spike in volatility. But it also shows that periods of volatility are a regular occurrence in investment markets. The circles in the chart show just how often volatility occurs. Unfortunately, during such times, people get jumpy and try to predict where the market is going, selling off equities or becoming scared of investing in them.

Despite everything most market 'experts' say, investing is not a struggle, a battle, a game or a contest; it is a continuous process that lasts a lifetime. Whether you are winning or losing at any given moment is beside the point. The only thing that matters is whether you prevail in the end – and the factors that may determine long term victory are the exact opposite of the ones that tend to create short term success.

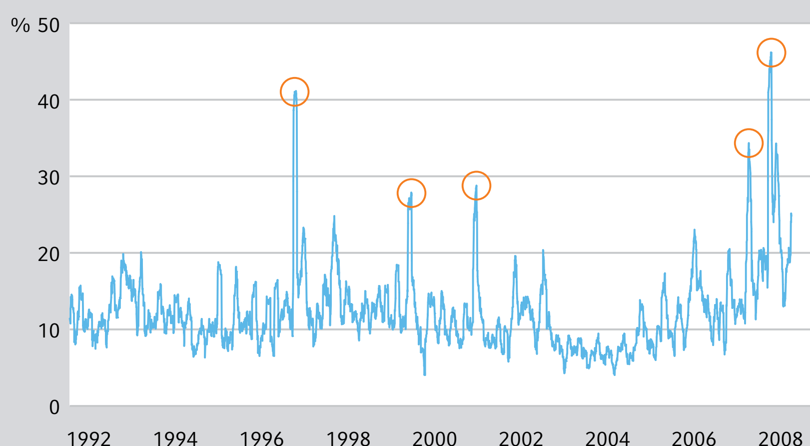
Occasionally in the short run, investors who can't let go – who track every market move – come out on top. But the longer they keep at it, the more likely these same people are to become 'losers'. That's because obsessing over the markets leads you to think you can foretell the financial future. You then make increasingly aggressive bets, and sooner or later, you may experience either heartburn or heartache. Fortunately, you can break this destructive pattern. The secret weapon is based around self control, and successful investors put this to work simply by adopting a virtuous approach to investing.

A virtuous approach to successful investing

Living with market volatility isn't easy. The first thing you can do during a change in the market is talk with your financial adviser to look at your investment goals, time horizon, financial circumstances and risk tolerance in order to adapt your investment strategy accordingly. But the values that influence our daily lives also apply to investing. If you understand these basic principles, you'll be a better equipped and more confident investor.

"investing is not a struggle, a battle, a game or a contest; it is a continuous process that lasts a lifetime"

Chart 1: Market Volatility as measured by standard deviation from May 1992 to June 2008



Source: ASX 300 Accumulation Index; 1 month rolling standard deviation of daily returns

Figure 1: Investment Power Tools

Diversity	Stop betting and start winning	Invest regularly	Rebalance
Regardless of market conditions, an investor's best defence is always a well-planned allocation strategy and well-diversified portfolio. Diversify your investments and nominate a percentage to put into various market sectors – for example, investing 60% in Australian and international shares, 20% in bonds, 10% in property and 10% in cash. Remembering that the gain or loss on any one individual investment represents just a portion of your portfolio	If you're really sure a security, fund or industry sector could return a significant gain, invest only a small allocation of your total assets. By remaining disciplined and sticking to your original strategy, you'll be rewarded if your instinct is correct, but won't suffer a major loss if you happen to be wrong.	Dollar cost averaging is systematic investing; that is, investing a small amount of money on a regular basis. A trick used by experienced investors, dollar cost averaging means that when market prices are falling, you automatically buy more units in the fund with each subsequent investment, and vice versa. Because of this, the average unit price of your investment will be under the average market price, therefore providing an efficient investment strategy.	Finally, once or twice a year, adjust your assets so they match the target percentages you picked earlier. That will force you to sell a bit of whatever has gone up and buy a bit of whatever has gone down – reversing the tragic buy-high, sell-low pattern that plagues most investors.

Courage

Investing in shares is risky, but it's a calculated risk

Think about the recent sharemarket gyrations as something like a dice, but with more than six sides. This 'super dice' has more positive sides than negative sides. Each time market forces roll this dice, you take a chance on the outcome.

So the first half of 2008 brought us negative results. As the dice is rolled for the next month, quarter or year, we take the risk that it could again land with a negative side facing up. But our chances for seeing a positive number next time are still greater than the chance of negatives. Historically, the sharemarket positive numbers have outweighed the negative numbers over long periods of time. There's no reason to believe that they will not continue to do so in the future.

Honesty

Be honest to yourself about how much you really know

Be honest about – and constantly test – what you don't know. Decades of research by the world's leading psychologists has shown that overconfidence – thinking that you know more than you really do, or that you are more skilful than you actually are – is one of the most fundamental aspects of human nature. Back in 1999, when you could invest money into just about any tech stock and watch it triple in two days, one of the single most common phrases in the world of investing was "I am a genius." In fact, anyone who made money trading shares without first studying the underlying companies had a lot of dumb luck, but not one iota of genius.

Successful investors accept not just the possibility – but the certainty – that they will be wrong much of the time. You need to protect yourself against being wrong in two dimensions: space (picking the wrong investments) and time (buying when you should sell, or vice versa). Overconfident investors are convinced they're right in both dimensions – just when they are most likely to be wrong. Fortunately, powerful protection is available (see Figure 1). Putting all these protective tools to work at once will provide you with the closest thing to real peace of mind an investor can get.

Detachment

Remaining neutral in your investment approach

There is certainly a tendency for the media to excite viewers and readers about short term fluctuations in the market – getting investors all hot and bothered about the fortunes of individual securities, countries and sectors. Even in the daily news, you don't have to look far to find examples of financial shock therapy. The sharemarket plummets and the headlines warn of economic armageddon. Oil prices soar and another investment 'expert' touts the need to buy shares in energy companies. Investors are far better served to detach from the constant noise beat up from the media.

The long term ride to wealth accumulation or preservation, an honest confrontation of risk and reward – implemented via a carefully selected asset allocation – is the only way to prepare for unpredictable volatility. It is important to accept that the value of your investments will rise and fall in the short term based on market behaviour which is out of your control. And that's okay if what matters is the size of your account balance on retirement day, not tomorrow or next week. It also makes reading about plummeting individual shares and spectacular booms much less painful.

Figure 2 – Comparing investors

$100,000 Investment (1990)	Type of Fund Invested In	% Return (2007)	$ Return (2007)
The 'Chaser' or 'Bailer'	Chases top performing asset sector (switching once a year on 1 Jan)	8.9%	$427,452
The 'Sticker'	Diversified Portfolio (consisting of: 32% Aus Shares, 15% International Shares, 15% International Shares Hgd, 8% Property, 15% Aus Bonds, 10% Int Bonds, 5% Cash)	10.3%	$587,526

Discipline

Don't let emotion rule your investment strategy

Often during a strong market upswing (rising equity prices), investors will instinctively buy 'so as not to be left out of the gains'. Conversely, during a strong downswing (falling equity prices), investors will feel compelled to sell 'so as not to be left wearing the losses'

The most successful investors will be those who stay in control while others may panic. It's easy to let short term market movements affect and even dictate your investment decisions. Which is why it's important to understand the role that investor sentiment and emotion plays in the cyclical nature of equity markets.

Commitment

Get in – and stay in

Figure 2 compares two investor types: the 'Sticker' and the 'Bailer'. When both invested $100,000 over a 17 year period, the Sticker who committed to a diversified portfolio clearly benefits from a higher return.

Now consider a 'Bailer' or 'Chaser' – a hypothetical investor – also starting with $100,000 in 1990 – who chases the top performing asset sector each year and switches on 1 January every year.

During the same time period, this investor would have changed their asset allocation 17 times. By the end of 2007, their average annual return would have been 8.4% and investment worth $427,452. As you can see in the table, our 'Sticker' fared much better.

The tax implications of selling your shares or 'Bailing', should also be considered, as they may offset any positive impact of selling. It is worth investigating how much tax you would have to pay before you decide to sell.

Remember that your investment strategy should be selected based on your risk tolerance, age, how long you plan to work, financial circumstances, retirement goals, and attitudes about investing. And it's important that you stay committed to your strategy and don't alter it unless your life changes.

The Point

These simple principles will not necessarily make you wealthy

One's approach to investing can be handled with the same grace we strive for in other aspects of life. So run through these five principles next time the market nosedives or you're tempted to act on a 'hot tip' from a friend or co-worker. As Socrates said, "Virtue does not come from wealth, but wealth, and every other good thing which men have, comes from virtue.

"When it comes to investing, many of us focus on risk and reward, and may fall prey to temptations such as greed. But the principles that influence our daily lives also apply to investing."

Your financial adviser can answer your questions on investing in volatile markets. Alternatively, for further information you can access Russell's range of Fact Sheets and other material, which are available on russell.com.au

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