Point of view

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We are part way through a financial market crisis which has driven prices in many markets below their true value.

AXA's Chief Investment Officer Mark Dutton looks at the investment opportunities that current market dislocations have created, and argues that investors who wait for 'signals' before committing to the market may be increasing their long-term risk.

Don't rely on the crystal ball

In brief

- ***Basing investment strategies on 'expert's' predictions as to whether the market will go up or down in the short term is a losing strategy***
- ***Investors who wait for signals before committing to the market increase their long-term risk***
- ***The unexpected events of 2008 have thrown up some extraordinary investment opportunities for long-term investors***

Rolling out the predictions

The crystal ball is being polished up. After predicting that the Australian sharemarket would reach as high as 7000 in 2008, experts are already tipping that the Australian sharemarket will rise somewhere in the range of 13 per cent to more than 40 per cent in the year ahead.

While it's true that current valuations provide plenty of room for markets to rally, investors who base strategic decisions on these kinds of predictions increase their risk – the track record on getting this right is very poor.

Lessons from history

2008 was an unusually tough year for investors. The credit crisis and massive de-leveraging that took place led to unprecedented levels of market volatility and market returns that were among the worst on record. The global sharemarket finished the year down by 25 per cent in Australian dollars. The US sharemarket fell by 38 per cent and the Australian sharemarket experienced its worst annual result on record (including the 1987 crash) with the market dropping by 41 per cent.

Over the past 100 years, there have been 10 occasions where the sharemarket has fallen by over 20 per cent and it has taken an average of 22 months for the market to reach new highs. Yet in the midst of each major downturn, it was unclear how long it would last or how it would be resolved. And it looked like a very bad time to invest.

Sharemarket recoveries are typically quick, with the exception of The Great Depression

Period	Magnitude of decline %	Length of decline (months)	Months to new high
1929-1933	(84)	34	152
1903	(26)	13	13
1907	(34)	14	13
1914	(25)	24	11
1917	(28)	13	17
1921	(26)	20	10
1937	(50)	13	63
1946	(22)	6	35
1962	(22)	6	10
1970	(29)	19	9
1974	(43)	21	21
1987	(30)	3	18
2002	(45)	25	49
Average*	(32)	15	22
2008/2009	?	?	?

Source: Center for Research in Security Prices, Shiller, Standard & Poor's and AllianceBernstein.
* Average excludes the 1929–1933 period

Traps in making decisions – using price as a signal to invest

Anxiety about the way in which markets behaved in 2008 is understandable. The volatility was real – almost 4 times the historical average for the US market and 13 times the historical average for the Australian market.

Research shows that in times of increased uncertainty investors tend to place too much emphasis on price as a signal to invest. However, the magnitude of recent sharemarket falls is not a measure of value, but the outcome of the price that the sellers accept in a market that has poor liquidity and limited buying interest.

This was the case in 2008, with hedge funds accelerating the de-leveraging in financial markets and investors pulling money out of mutual funds and favouring cash accounts. In the month of October alone, US mutual funds suffered net outflows of US$126 billion.

The result is some extraordinary investment opportunities for those who are willing and able to see past the current issues. Equity prices have now fallen to levels which allows for a recession and substantial declines in profit growth. For example, the current price/earnings (P/E) ratio for the Australian sharemarket is around 9 times, while the average P/E ratio for the Australian market over the past 30 years is close to15 times. The markets have effectively factored in an earnings decline of almost 40 per cent.

News reports over coming quarters will sound very negative as companies report their declining earnings and poor outlook. For those who have done the homework, this is not news, and is more than compensated for by the low prices that have now been reached.

The extremes of recent events heighten the risk that investors who wait for the price signal will invest at the wrong time – reinforcing the losing strategy of buying high and selling low. Research undertaken by the US firm DALBAR Inc. which looked at investor behaviour over a 20 year period found that the average US share investor achieved a return of 4.3 per cent per annum even though the funds they invested in returned 11.8 per cent per annum. Mistiming the market created extra risk and meant that these investors did not receive the full potential of their investment.

2008 - an extraordinary year

- The collapse of the historic US investment bank Lehman Brothers in September brought the world to the brink of a banking and liquidity crisis
- Governments around the world aggressively intervened, in many cases taking control of troubled institutions and facilitating mergers and takeovers, providing debt facilities and buyout arrangements for troubled assets
- The early implementation and level of global economic stimulus is history in the making
- US interest rates have dropped to their lowest rate on record
- The interest rate spread on higher risk corporate bonds reached its highest level in more than 70 years
- The rush to ‘safety’ pushed interest rates on sovereign government bonds to new historic low levels
- Current sharemarket valuations appear attractive for investors willing and able to see past the current issues

Opportunities in bond markets

Current market dislocations have also created investment opportunities for bonds. Credit markets are yet to begin to operate normally, meaning that prices (or yields) are out of line. The unusually high yields on corporate bonds will provide either an attractive return to maturity or a large capital gain if markets revert to fair value prior to maturity. Conversely, government guaranteed bonds are now so expensive that returns will be well below long-term investor requirements, and may generate a capital loss as yields rise again in the future.

Cash is a poor investment strategy

In 2008, safety became synonymous with cash. In 2009, the decision to hold cash over long-term growth assets is already becoming increasingly expensive. At 7 per cent, the dividend yield for the Australian sharemarket is now higher than the average 4 per cent return investors can receive from term deposits. If we take franking credits into account, the effective dividend rate is nearly double most prospective cash returns.

Confidence in the future

Trying to time a market recovery is fraught with danger. While we can be confident that markets will recover, we can't rely on crystal ball predictions to tell us when the current abnormal markets will return to normal. Using sharemarket predictions and price as a signal to invest leads to poor investment decisions that increase risk. A more reliable strategy is to focus on having a quality investment portfolio that is well positioned for potential gains when markets re-assess asset values in the future. When that occurs, strong returns are likely to come from markets that are currently distressed.

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