Capital Strategies

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Pessimistic Views, Enduring Realities: Practical Strategies for Investors

The FTSE 100 index, the bellwether of the UK economy, fell by 7% last week. Yet on Monday it closed up 3.9% at 5446 as investors responded to the news that the US Federal Reserve would effectively bail-out the heavily indebted mortgage guarantors, Fannie Mae & Freddie Mac. The continuing fallout from the credit crunch has caused considerable investor pessimism both in the UK and worldwide, resulting in investors downgrading their expectations for future economic growth, corporate profits and investment returns. The FTSE 100 is still 19% lower than its most recent peak of 6732 achieved in June 2007. Stock market falls are always unnerving for existing investors with many adopting a more defensive stance by shifting their portfolios' asset allocation to low risk assets such as cash. Investors currently holding cash are also afraid of committing long-term monies to the stock market. Both sets of investor hope to switch from cash into equities when the economic outlook improves and expectations of future equity returns turn positive. Are these investors adopting the right approach?

Trying to time the market requires two decisions – when to get out and when to go back in. Getting either of these decisions wrong can lead to disastrous results. Table 1 illustrates the problems.

Table 1: Equity returns come in bursts

Feb 1955 to April 2008

UK Treasury Bills (Cash)	Average Monthly Return
All 639 months (100% of time)	0.62%

FTSE All-Share Index	Average Monthly Return
All 639 months (100% of the time)	1.14%
Best months (12% of the time)	9.60%
All other months (88% of the time)	0%
615 months (96% of time to match cash returns)	0.62%

Source: Collins Ward Capital Management 2008

From 1955 to 2008 the average compound return from the UK stock market was 1.14% per month. However, this number is deceptive. If you strip out the best 77 performing months (12% of the time) your return would have averaged 0% per month – yes that's right, 0%. If you missed out on the best 4% of months over the 53 year period, you wouldn't even have beaten the returns that you could have earned from keeping your money in cash. Obviously this is a simplistic example of a worst case scenario, as by missing out on the best periods an investor would undoubtedly have missed out on some of the worse periods as well. But the salutary warning is that attempting to time markets is a very hazardous strategy – get it consistently right and you may indeed make

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exceptional returns, but occasionally get it wrong, and you will be far worse off than if you had just followed a simple 'buy and hold' strategy.

The seductive siren call of market timing will continue to entice many private investors, while seasoned money managers and experienced investors will steer clear of such strategies. Why should it be so hard to make money by making decisions on the current and forecast economic conditions, stock market valuations, historical evidence and political environment? Surely professional investors, with their vast analytical resources can weigh up all the variables and make sound, reasoned and successful judgements. They obviously won't be right all the time, but surely they will be right more often than not? Nobel Prize winning economist William Sharpe demonstrated[1] that an investor switching between the stock market and cash would need to be right over 70% of the time over a protracted period to achieve a greater return than a 'buy and hold' investor. The reason why these odds are so unattractive lies in understanding how markets work. Movements in investment markets follow no discernible patterns; they follow what is often referred to as the *random walk* exhibited by a drunkard stumbling down a street and weaving uncontrollably from side to side. No one can foresee which way he will move next, forwards, backwards, left, right or even fall over. The market's random movements prevent an investor who makes sound reasoned judgements from making money from market timing, as the market does not react in a reasoned or expected manner to various stimuli.

Human beings, driven by the twin emotions of greed and fear can act very irrationally when making investment decisions. Benjamin Graham, the father of modern investment analysis, compared the stock market to a manic depressive schizophrenic business partner called Mr Market. One day he would be euphoric and could only see the positives in the economy, therefore valuing his and your shares in your jointly owned company at a very high level. On another gloomier day, he would be overly pessimistic and wanting to sell his shares to you at a knockdown price to avoid perceived forthcoming economic and company woes. The value Mr Market placed on your shareholding would fluctuate from day to day based upon his emotional state – would you as a level headed business owner use Mr Market's methodology when valuing your shares? History has shown us that we are too optimistic in runaway bull markets and then overly pessimistic in bear markets.

It is understandable that cash investors feel more comfortable adopting a 'wait and see' approach. But at what point will they act, or will continuing uncertainty condemn them to forever retaining cash in the bank. Waiting for the economic data to turn positive is unlikely to be sensible. In fact, economic trends have historically not been accurate predictors of future stock market performance. Table 2 shows four separate economic signals, which many investors believe signal a stock market downturn. However, it is more than likely that the markets will rise in the twelve months that these 'negative' economic indicators dominate the news.

Table 2: Economic trends do not reliably predict stock market performance

Economic Indicators	Number of rolling 12-Month periods	UK Stockmarket Direction Over same 12 Months	
	(1950 - 2006)	Market Up	Market Up
Recession*	26	82%	18%
Rising Interest rates**	219	69%	31%
Gold Prices Rise by 10+%	197	77%	23%
Oil Prices Rise by 10+%	158	72%	28%
FTSE Average (1950 - 2006)		76%	24%

* A recession is defined as a decline in average GDP growth for four successive quarters.
** 10 Year UK Government Bonds
Source: Alliance Bernstein. "Staying the course: Why it pays to stand firm through volatile markets". 2007

The explanation for this is relatively simple. Mature economies such as Europe and the US have very *efficient* stock markets. What do I mean by efficiency? The market is made up of millions of investors all trying to maximise profits and minimise losses by buying investments that offer the highest risk adjusted returns and selling those that offer the lowest returns. This process is never ending and the result of the consensus view of all market participants is the current market price for a particular asset. This consensus view changes by the second as investors assimilate the economic, political, industry and company specific news as it emerges. In the modern world news can be transported to any location in the world at the touch of a button. So the reality is that as soon as news becomes available, investors are

[1] "The likely gains from market timing". W Sharpe. *Financial Analysts Journal* 31 (March/April 1975). pp 60-69.

acting on it and changing prices. Market prices are not always 'right' but they are the sum total of all investors' expectations of future economic conditions. Markets are very forward reaching and if you think that you can act by selling out of the market after bad news or buying in after good news then you are already likely to be too late. Remember the figures from Table 1 and the impact of missing out on sharp recoveries. As far back as 1938, the eminent economist JM Keynes[2] clearly outlined the argument against market timing – his words are just as relevant today.

> **"…the idea of wholesale shifts is for various reasons impracticable and indeed undesirable. Most of those who attempt to, sell too late and buy too late, and do both too often, incurring heavy expenses and developing too unsettled and speculative a state of mind."**

Conclusion

Constructing a diversified portfolio from multiple asset classes will help reduce portfolio volatility, but remember, the reward for accepting volatility is the risk premium offered by risky assets such as equities. Throughout the 20th Century the UK stock market delivered an annualised *risk premium* of 6.5%[3] above cash returns. This premium was not available every year, but patient investors were consistently rewarded over the long-term. Trying to move in and out markets is not investing but speculation. The majority of equity returns come from a few small periods of exceptional growth, miss these and you may as well just keep your money in cash – you'll probably do better and have fewer sleepless nights.

Clients holding long-term growth portfolios should not consider liquidating their equity holdings - in fact they should follow a disciplined strategy of rebalancing their portfolio. Rebalancing brings a portfolios asset allocation back in line with the strategic allocation that is deemed most suitable for the long-term achievement of their objectives. It involves trimming those investments which have performed well and topping up those that have fallen, effectively 'selling high, buying low'. Following such a strategy requires discipline in both rising and falling markets but is a sure-fire way to improve long-term investment returns.

Existing cash investors holding off from implementing long-term portfolios should reconsider their objectives and situation. These investors should not let short-term market conditions dominate their long-term planning. If the thought of plunging into the market at this point is too much to bear, then a phased investment approach of gradually increasing exposure to risk assets is a sensible compromise.

The Credit Crunch is only the latest in a very long line of economic upheavals, and it certainly won't be the last. Stock market uncertainty is an ever present feature of investing and is the very reason why equities have to offer returns in excess of cash. The risk premium for holdings equities has actually been higher historically than we would have expected – in many ways this is because so many investors demonstrate a distinct aversion to short-term losses, and therefore retain far greater allocations to lower risk assets than their situation would sensibly suggest. Stock market corrections actually increase the future expected returns available from equities as investors attribute a higher risk level to equities thus demanding higher returns. Stock markets are one of the few places where the lower the prices fall, the fewer people wish to buy – when prices start to rise again people will undoubtedly be queuing up to buy – this is the enduring reality of investment markets.

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[2] "Memorandum for the Estate Committee", King's College, Cambridge, 8 May 1938
[3] The historical risk premium quoted is the annualised mean. "Triumph of the Optimists. 101 years of global investment returns." Dimson, E. Marsh, S and Staunton, M. (2002). Princeton.