

Five charts on investing to keep in mind in rough times like these

March 2020

Key Points

- > Successful investing can be really difficult in times like the present with immense uncertainty around the impact of coronavirus on the outlook.
- > This makes it all the more important to stay focussed on the basic principles of successful investing.
- > These five charts focus on critical aspects of investing that are insightful in times of market stress: the power of compound interest; don't get blown off by cyclical swings; the roller coaster of investor emotion; the wall of worry; and market timing is hard.

Introduction

The coronavirus crisis is first and foremost a human crisis and our thoughts are particularly with those on the front line of this battle.

But, of course, it's impacting many aspects of life at present, including investment markets.

Successful investing can be really difficult in times like the present when markets have collapsed into a bear market with falls globally of around 30% from their highs amidst immense uncertainty about the economic hit from coronavirus and how much policy stimulus and central bank support can head off collateral damage and boost an eventual recovery.

Trying to work this out is driving huge volatility in investment markets making it very easy for short term traders to get whipsawed.

As the US economist, JK Galbraith once said "there are two types of economists – those that don't know and those that don't know they don't know." And this is certainly an environment where much is unknown.

But while history does not repeat in that each cycle is different, it does rhyme in that each has many common characteristics. So, while we haven't seen a pandemic driven bear market before the basic principles of investing have not changed.

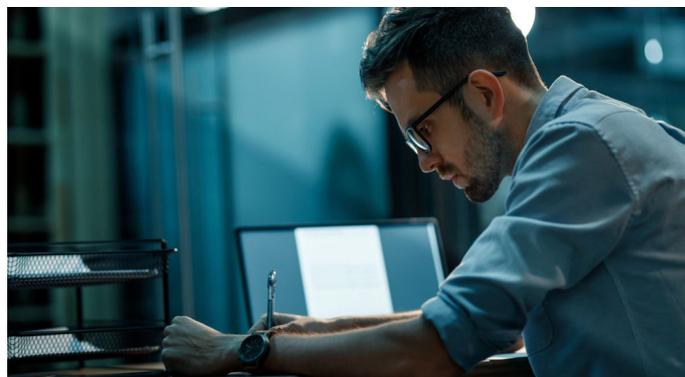


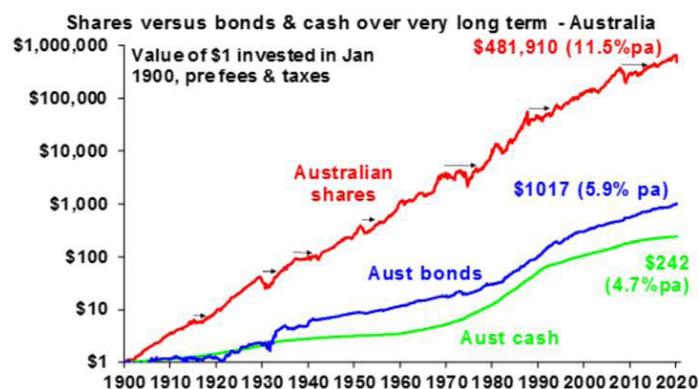
Chart No. 1: The power of compound interest

This chart shows the value of \$1 invested in various Australian assets in 1900 allowing for the reinvestment of dividends and interest along the way.

That \$1 would have grown to \$242 if invested in cash, to \$1017 if invested in bonds and to \$481,910 if invested in shares.

While the average return since 1900 is only double that in shares relative to bonds, the huge difference between the two at the end owes to the impact of compounding - or earning returns on top of returns.

So, any interest or return earned in one period is added to the original investment so that it all earns a return in the next period.



Key message:

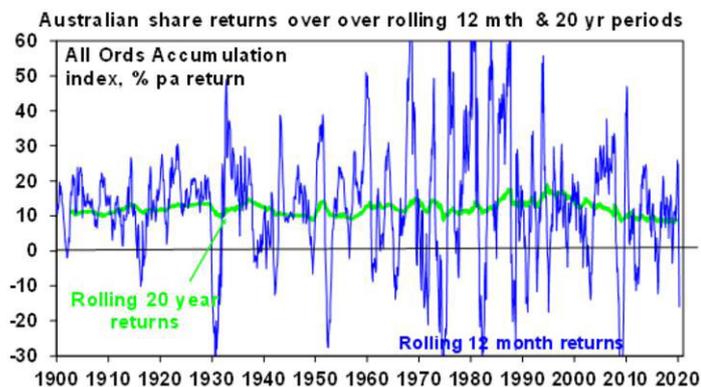
To grow our wealth, we must have exposure to growth assets like shares and property. While shares have collapsed lately amidst massive coronavirus uncertainty and the short-term outlook for Australian housing is vulnerable too, both will likely do well over the long-term.

Chart No.2: Don't get blown off by cyclical swings

The trouble is that shares can have lots of setbacks along the way as is evident during the periods highlighted by the arrows on the previous chart. Just like now.

Even annual returns in the share market are highly volatile, but longer-term returns tend to be solid and relatively smooth as can be seen in the next chart.

Since 1900, for Australian shares roughly two years out of ten have had negative returns but there are no negative returns over rolling 20-year periods.



The higher returns shares produce over time relative to cash and bonds is compensation for the periodic setbacks they have. But understanding that these periodic setbacks are just an inevitable part of investing is important in being able to stay the course and get the benefit of the higher long-term returns shares and other growth assets provide over time.

Key message:

Short-term sometimes violent swings in share markets are a fact of life but the longer the time horizon, the greater the chance your investments will meet their goals. So, in investing, time is on your side and it's best to invest for the long-term when you can.

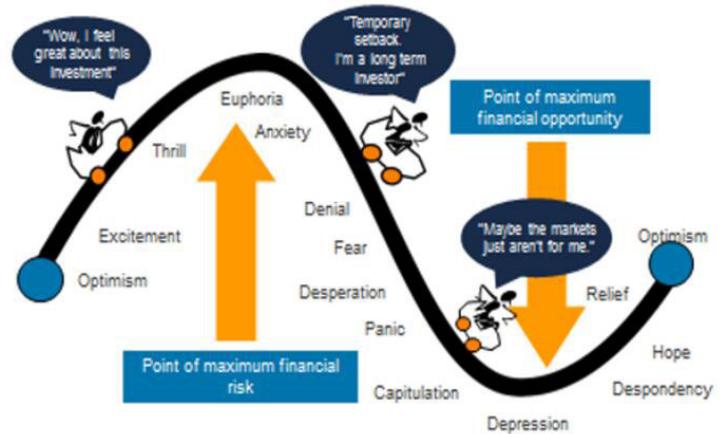
Chart No. 3: The roller coaster of investor emotion

It's well known that the swings in investment markets are more than can be justified by moves in investment fundamentals alone - like profits, dividends, rents and interest rates.

This is because investor emotion plays a huge part. This has been more than evident over the past few weeks. The next chart shows the roller coaster that investor emotion traces through the course of an investment cycle.

Once a cycle turns down in a bear market, euphoria gives way to anxiety, denial, capitulation and ultimately depression at which point the asset class is under-loved and undervalued and everyone who is going to sell has - and it becomes vulnerable to good (or less bad) news.

This is the point of maximum opportunity. Once the cycle turns up again, depression gives way to hope and optimism before eventually seeing euphoria again.



Key message:

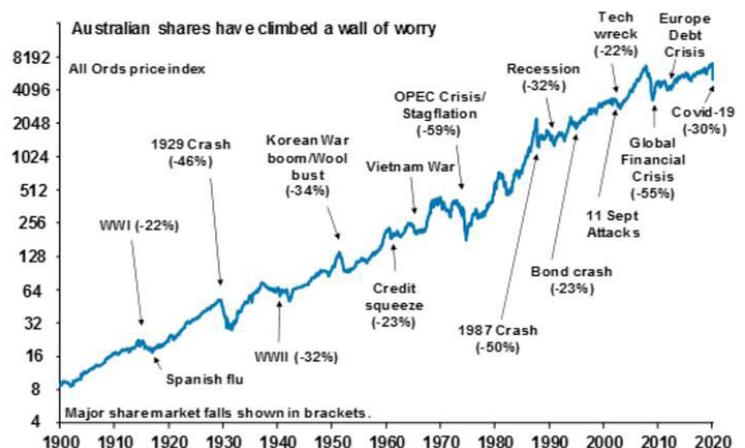
Investor emotion plays a huge role in magnifying the swings in investment markets. The key for investors is not to get sucked into this emotional roller coaster. Of course, doing this is easier said than done which is why many investors end up getting wrong footed by the investment cycle.

Chart No. 4 The wall of worry

There is always something for investors to worry about. And in a world where social media is competing intensely with old media it all seems more magnified and worrying. This is arguably evident now in relation to coronavirus uncertainty.

The global economy has had plenty of worries over the last century, but it got over them with Australian shares returning 11.5% per annum since 1900, with a broad rising trend in the All Ords price index as can be seen in the next chart, and US shares returning 9.6% pa.

Note that this chart shows the All Ords share price index whereas the first chart shows the value of \$1 invested in the All Ords accumulation index, which allows for changes in share prices and dividends.



Key message:

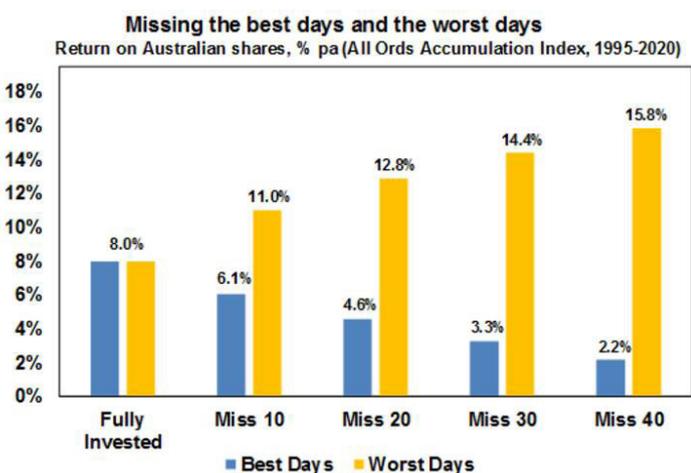
Worries are normal around the economy and investments and sometimes they become intense - like now. But they eventually pass. And so, it is with coronavirus - this too will pass eventually.

Chart No. 5: Timing is hard

The temptation to time markets is immense. With the benefit of hindsight many swings in markets like the tech boom and bust and the GFC look inevitable and hence forecastable and so it's natural to think why not switch between say cash and shares within your super to anticipate market moves.

This is particularly the case in times of emotional stress like now when all the news around coronavirus and its impact on the economy is bad. Fair enough if you have a process and put the effort in. But without a tried and tested market timing process, trying to time the market is difficult.

A good way to demonstrate this is with a comparison of returns if an investor is fully invested in shares versus missing out on the best (or worst) days. The next chart shows that if you were fully invested in Australian shares from January 1995, you would have returned 8% pa (with dividends but not allowing for franking credits, tax and fees).



If by trying to time the market you avoided the 10 worst days (yellow bars), you would have boosted your return to 11% pa. And if you avoided the 40 worst days, it would have been boosted to 15.8% pa!

But this is very hard, and many investors only get out after the bad returns have occurred, just in time to miss some of the best days.

For example, if by trying to time the market you miss the 10 best days (blue bars), the return falls to 6.1% pa. If you miss the 40 best days, it drops to just 2.2% pa.

Key message:

Trying to time the share market is not easy.

Further information:

Richard Shermon

Reserve Financial Consulting

Suite 4, 10 Station Road
Cheltenham VIC 3192

Ph: 0401 357 071

E: richard@reservefc.com.au

W: www.reservefc.com.au