Bad Time to Invest?

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Contents

Introduction

This report aims to help retail investors make better informed long-term investment decisions. Knowing the right time to invest and what is likely to happen going forward, can assist investors when planning their longer term investment strategy. This report is especially useful to investors approaching retirement and investors in retirement. All our clients invest in investment funds and use tax-wrappers such as Stocks & Shares ISAs and SIPPs and the majority of them have in excess of £100,000 actively invested.

Typical clients are business owners and professionals such as doctors, dentists and lawyers. We also cater for high level corporate executives and financial services professionals such as hedge fund managers, wealth managers and IFAs. This report is aimed at investors matching our client description who are looking for guidance and insights into an effective ISA and SIPP investment strategy for the long term.

In this report we will first ask the question, ‘When is the best time to invest?’ and discover the emotions investors experience during a typical market cycle. After viewing this section you’ll understand why the greatest investor in the world, Warren Buffett, has frequently been quoted as saying “A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful.”

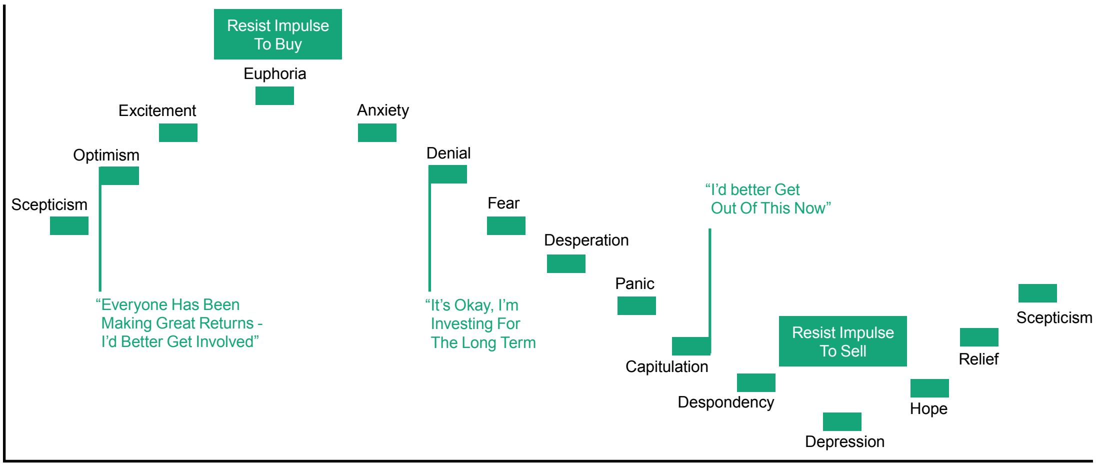
In ‘Buying high and selling low’ we support the theory that most investors buy and sell at the wrong time by showing you evidence that illustrates historic net investment flows into equity funds by UK investors. You’ll discover that the data suggests most retail investors do unfortunately buy at the top and sell at the bottom.

We also present evidence that suggests a positive outlook for the global markets over the next ten years and the data suggests that it will probably be a decade of outperformance.

Please note, past performance should not be used as a guide to future performance, which is not guaranteed. Investing in funds should be considered a long-term investment. The value of the investment can go down as well as up and there is no guarantee that you will get back the amount you originally invested.

When is the best time to invest?

We can all agree that the point of maximum financial opportunity is right at the bottom of the market and the point of maximum financial risk is right at the top of the market. The challenge investors face is that when the market is at its bottom, no investors 'feel' like investing. And when the market is at its top, most investors find it hard not to buy, again because of how they 'feel.' All too often investors are influenced by short-term market movements rather than focusing on the longer-term trend and how this fits with their own investment objectives.

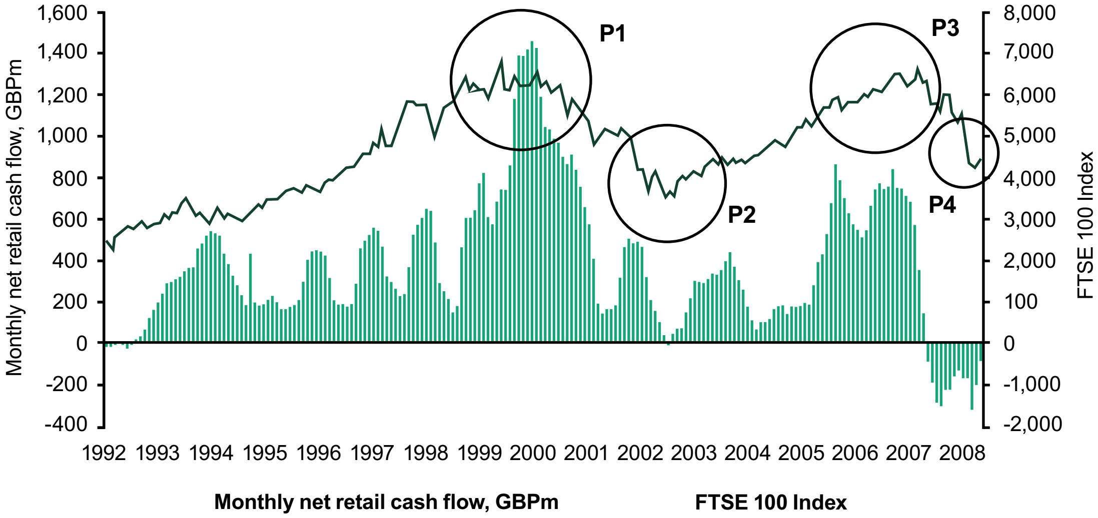


Source: Adapted from Westcore Funds / Denver Investment Advisors LLC

As the chart illustrates, many investors go through a range of emotions at different points of a market cycle. Unfortunately, all too often this can result in investors entering or exiting the market at precisely the wrong time. As markets peak, investor sentiment is running high with emotions of excitement thrill and euphoria, tempting investors to flood into highly priced markets. But as markets dip, sentiment begins to run low and negative emotions of panic, despondency and depression lead investors to exit the market and realise a loss.

Buying high and selling low

To support the theory that most retail investors buy and sell at the wrong time, the next chart shows historic net investment flows (investment purchases minus investment sales by retail clients) into equity funds by UK investors alongside movements of the FTSE 100 Index, between 1992 and 2009.



For illustrative purposes only.
Source: IMA, MSCI. Monthly cash flow data shown relects 6 month moving average.

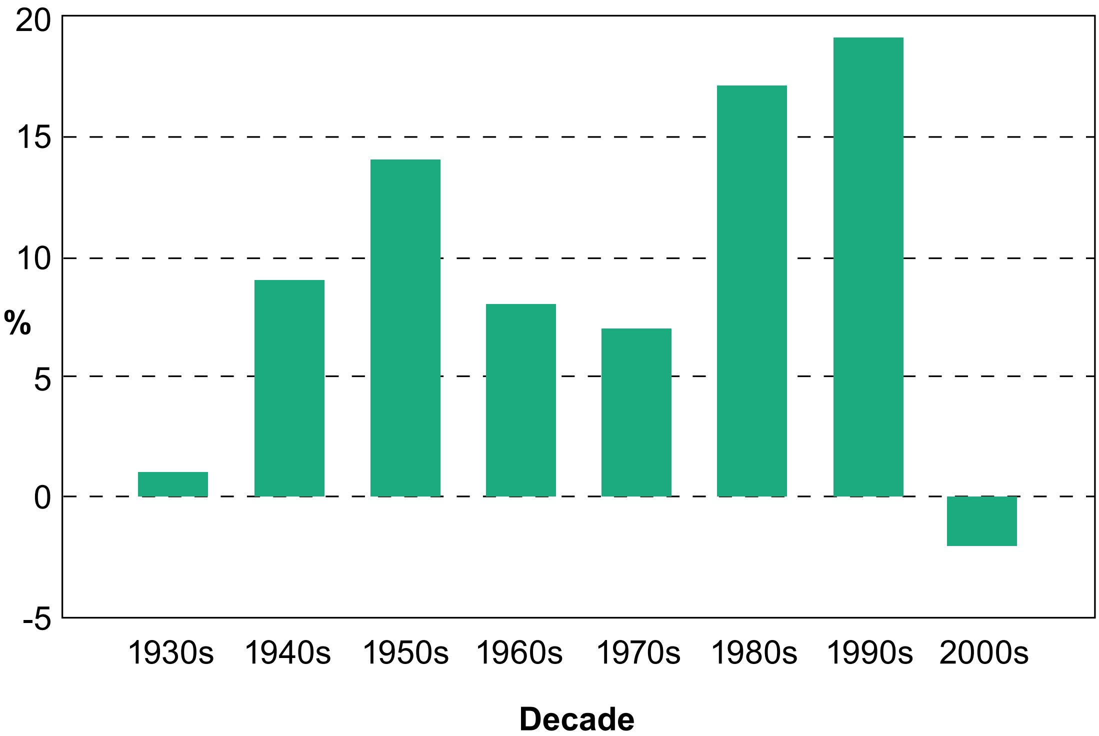
As can be seen, investment flows increase significantly as markets peak, especially during P1 in 2000 and P3 in 2006/2007, and conversely decrease during market dips, especially during P2, 2002 and P4 in 2008 when we see net outflows (i.e. more sales than purchases by investors) from funds.

A difficult time to invest

This is definitely a difficult time to invest. It's easy to be put off by the markets sudden rises and falls – you will need to keep a clear head when many other people are losing theirs. However, it's worth remembering that there are investment opportunities in the difficult periods as well as the good times.

For all the worry felt by some that the world is facing unprecedented economic challenges from which it will never recover, history tells us differently. True, there are new issues including the shifting power from West to East, and the huge impact of the Internet on globalisation. But the challenges faced by markets today are no different than the Great Depression of the 1930s or the crisis years of the 1970s. Just as in those decades, the crises facing developed world markets include Government indebtedness, high unemployment and economic stagnation. But both the 1930s and 1970s were followed by successive decades of massive growth, a return to strong levels of employment and, for investors, robust investment returns (see chart).

Returns of the Decades Since 1930 – Annualised Return on the S&P 500 in USD



Source: Thomson One, Jan 7, 2010
Past performance is not a guarantee of future results.

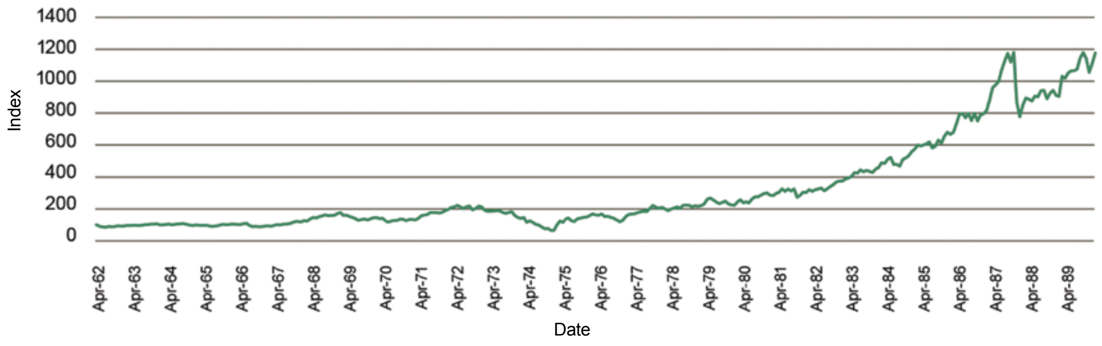
If history has any lesson to teach us about lost investment decades, it is that there is a cyclical nature to global economic markets. Abandoning the markets may have been an understandable response in the early 40s or 80s, but what a mistake it would have been!

A lost decade

Stock markets have suffered two sharp falls in the past ten years, and in many cases remain below their previous peak – some have even called this a 'lost decade'.

The last time the markets went through such an extended period of underperformance was in the 1960s and 1970s. By the start of the 1980s, many investors were shell-shocked by their experience and convinced that things could only get worse. However, someone who looked beyond the difficult conditions and bought when prices were low would have then enjoyed one of the best periods of extended outperformance in the market's history. This performance adds to the theory that the best time to invest can be when it feels most difficult to do so.

Stock market performance during the 1960s, 1970s and 1980s



Source: Datastream, 30.04.62. to 31.12.89.
This graph is based on the FTSE All-Share Price Index and uses the earliest available figures from the 1960's.
Please remember that past performance is not an indication of what will happen in the future.

Why is the long-term so important?

One of the important things for any investor to remember is that you shouldn't be worried by short-term fluctuations. It's easier said than done of course, but the point is that when you are investing for the long-term you should have plenty of time to ride out the market uncertainty.

Instead, you should focus on the bigger picture. In the case of the UK stock market, as represented by the FTSE All-Share Index, this is an average annual return of 7.2 per cent over the last 49 years (to 30/11/11). Don't forget, this period includes Black Monday, Black Wednesday, the dotcom bubble, the Russian financial crisis, the Asian financial crisis and the oil crisis – so there were definitely some downs as well as ups. Please remember, past performance is not a guide to future returns.

The resilience of the markets

The US's Standard & Poor's 500 Composite Index has experienced its share of 'shock events,' but for many decades the market has demonstrated an ability to overcome adversity.

The markets resilience has been particularly evident in its climb from the March 2009 low. Rarely does a year go by without a crisis of some sort and in 2011 the market had to deal with several shocking and surprising events, including the unrest in the Middle East and North Africa, and the earthquake and tsunami in Japan which has resulted in staggering loss of life and a crisis at a nuclear power plant.

After crises, the market has a history of regaining traction

The specific periods depicted are as follows: 1/1/60-3/31/11 (top chart) and 3/9/09-3/31/11 (bottom chart). The S&P 500 Index is unmanaged.

A look at about 50 years of the S&P 500's history shows that there has been no shortage of traumatic events. But decade after decade, the market has demonstrated its ability to climb a 'wall of worry.' Even since the markets low in March 2009, the S&P has demonstrated its strength in the face of issues ranging from the 'flash crash' to high unemployment.

Many of the events depicted on the chart have been traumatic and costly. The market, however, has not only survived, but thrived. For more than a century, the U.S. market has endured wars, recessions, assassinations, scandals and natural disasters and each time it has come back. Through it all, the market has demonstrated a remarkable strength and resilience in the face of challenges.

Periods of strength after weakness

Another piece of research that proves useful is the Barclays Gilt Study of 2009. History, once again, shows the returns enjoyed by investors who can overcome their instinct to seek a safe haven in difficult times could be significantly higher in the long-term.

When you look at history, you find that extended periods of poor performance have almost always led to periods of above average performance. As investment in equities should be viewed as a medium to long-term savings vehicle, the study looked at returns over ten year periods as illustrated in this table.

Barclays Gilt Study 2009

Average annual returns over 10 years	%	Average annual return in the 10 years immediately afterwards	%
1906 - 1915	-0.2	1916 - 1925	+3.9
1907 - 1916	-3.7	1917 - 1926	+6.5
1908 - 1917	-3.8	1918 - 1927	+9.1
1909 - 1918	-3.5	1919 - 1928	+10.3
1910 - 1919	-3.8	1920 - 1929	+7.8
1911 - 1920	-7.9	1921 -1930	+12.8
1912 - 1921	-5.1	1922 - 1931	+7.6
1913 - 1922	-1.9	1923 - 1932	+7.5
1914 - 1923	-1.3	1924 - 1933	+9.6
1965 - 1974	-6.0	1975 - 1984	+17.4
1967 - 1976	-0.3	1977 - 1986	+14.6
1968 - 1977	-0.2	1978 - 1987	+12.0
1969 - 1978	-3.5	1979 - 1988	+12.4
1970 - 1979	-2.3	1980 - 1989	+15.6
1972 - 1981	-2.4	1982 - 1991	+13.2
1973 - 1982	-1.2	1983 - 1992	+12.7
1999 - 2008	-1.5		
Average	**-2.9%**	**Average**	**+10.8%**

Source: Barclays Capital Gilt Study 2009 (based on FTSE All Share Index and includes dividends reinvested).

The Barclays study shows that since 1899 there have been 17 lost decades (10 year periods of negative aggregate performance) with an average annual return of -2.9 per cent. This includes the most recent decade (to the end of 2008) where UK equities suffered average annual returns of -1.5 per cent. Notice that each of the decades immediately following a lost decade has provided positive average annual total returns, with an average of 10.8 per cent per annum for these ensuing good decades. This data suggests to our investment expert that over the next decade we are likely to see above average returns. However this is not guaranteed.

Strength in the face of adversity

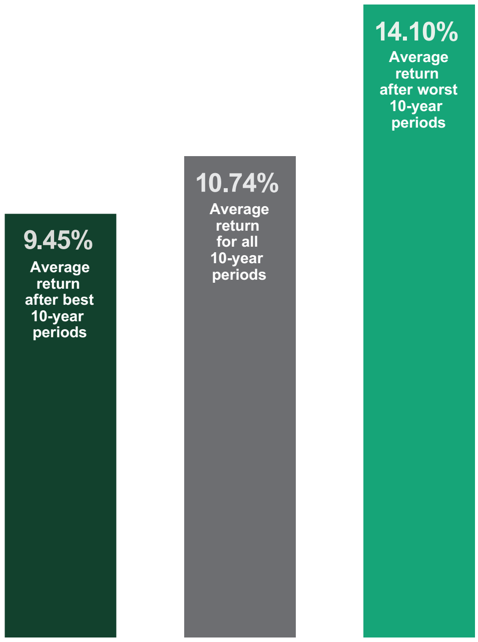
A look back at the modern history of the S&P 500 reveals a common pattern similar to UK equities. Over time, the market has demonstrated strength in the face of adversity and long-term investors have been rewarded.

After worst 10-year periods, returns have exceeded long-term average

S&P 500, rolling 10-year periods, 12/31/27–12/31/10

Best 10-year periods		Next 10 years
10 years ended …	Average annual total return	Average annual total return
1951	17.26%	16.42%
1952	17.06	13.44
1954	17.09	12.82
1955	16.67	11.07
1956	18.40	9.20
1957	16.41	12.85
1958	20.04	10.01
1959	19.34	7.82
1960	16.15	8.18
1961	16.42	7.06
1963	15.91	6.00
1988	16.32	19.19
1989	17.54	18.19
1991	17.58	12.93
1992	16.15	9.34
1997	18.02	5.91
1998	19.19	–1.38
1999	18.19	–0.95
2000	17.44	1.42
Average	**17.43**	**9.45**

Worst 10-year periods		Next 10 years
10 years ended …	Average annual total return	Average annual total return
1937	0.00%	9.61%
1938	–0.93	7.25
1939	–0.08	9.15
1940	1.78	13.36
1941	6.44	17.26
1946	4.41	18.40
1973	6.00	10.66
1974	1.23	14.81
1975	3.27	14.34
1976	6.64	13.84
1977	3.60	15.28
1978	3.17	16.32
1979	5.88	17.54
1981	6.49	17.58
1982	6.72	16.15
2007	5.91	N/A
2008	–1.38	N/A
2009	–0.95	N/A
2010	1.42	N/A
Average	**3.14**	**14.10**



Based on average annual total returns of 74 rolling 10-year periods, divided into quartiles. The range of returns for each quartile is as follows: Quartile 1 (top/best quartile), 15.91% to 20.04%; Quartile 2, 11.06% to 15.28%; Quartile 3, 7.06% to 10.66%; and Quartile 4, –1.38% to 6.72%. The average return for the years after the best and worst periods is the average of the average annual total return of the periods following each period in the top and bottom quartile, respectively. Data are not available for future 10-year periods; therefore, the last return for the "next 10 years" is for the period 12/31/00–12/31/10. The S&P 500 Index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or taxes.

The chart depicts returns for 10-year periods that fall into the top quartile and the bottom quartile since December 31 1927. A look at the 10-year periods can be instructive, given that the market recently recorded its worst decade, registering an average annual decline of 1.4 per cent for the 10 years ended December 31 2008. The 10-year period ended December 31 1958 had the highest average annual return of 20 per cent.

The data for the worst 10-year periods shows that the market has demonstrated the ability to recover and advance after extended periods of decline. For example, after a decade that fell into the bottom quartile, the subsequent decade provided returns that were not only higher and positive, but often higher than the 10.7 per cent average return for all rolling 10-year periods since 1927. Past returns aren't predictive of future results, but history suggests that equity investing may still hold an opportunity for long-term investors.

Conclusion

Most investors experience a whole range of emotions during different points of a market cycle. Unfortunately, all too often this can result in investors entering or exiting the market at precisely the wrong time. This theory was supported by data showing historic net investment flows (investment purchases minus investment sales by retail clients) into equity funds by UK investors alongside movements of the FTSE 100 Index, between 1992 and 2009.

We also discovered that for all the worry felt by some that the world is facing unprecedented economic challenges from which it will never recover, history tells us differently. For example, both the 1930s and 1970s were followed by successive decades of massive growth, a return to strong levels of employment and, for investors, robust investment returns.

We also learned what a mistake it would have been for the investors who abandoned the market in the early 40s or 80s. The lesson here appears to be to try to look beyond the difficult conditions and buy when prices are low. Adopting such a strategy in the past would have resulted in you enjoying some of the best periods of extended outperformance in the market's history. It also seems that the best time to invest can be when it feels most difficult to do so.

It also appears that the next decade could be one of outperformance – which means now could be a perfect time to be investing, as long as you are doing so for the long-term. Our suggestion is that unless you are going to invest in the stock market for a period of at least five years, you are better off not investing at all as it carries too much risk in the short-term. However if you have a long-term investment outlook, now could be seen as a golden opportunity.

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