Realistic sharemarket expectations

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Contents

Realities of sharemarket investing

Just as life has two certainties, the same is true for investing.

First, future investment performance is impossible to predict. This is the premise of economist and author Burton G Malkiel's random walk theory. In his best-seller *A Random Walk Down Wall Street* Malkiel explains, "A random walk is one in which future steps or directions cannot be predicted on the basis of past actions." When applied to the stock market this simply means, "short-run changes in stock prices cannot be predicted".

Second, markets will go up and markets will go down. Sharemarket investing is a long-term investment strategy, however, as this Plain Talk® guide will demonstrate, the sharemarket can be volatile over the short term. This is why it's just as important to be aware of the risks of investing in shares as well as the rewards.

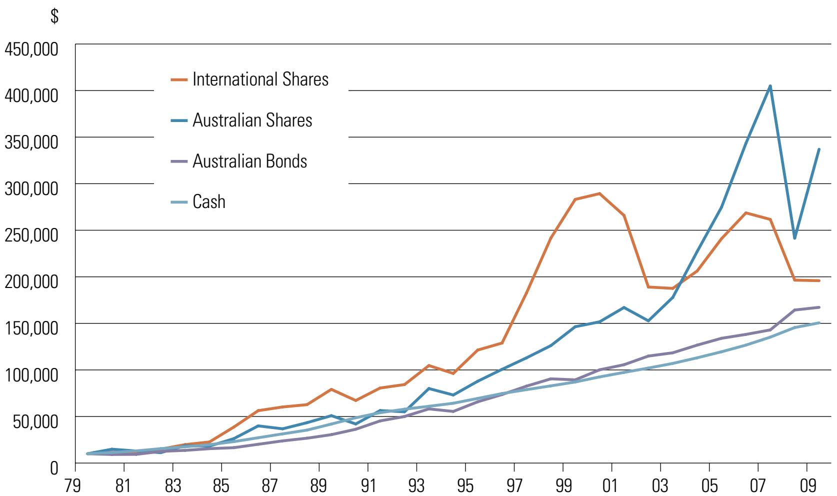
While past performance is no guarantee of future performance, this Plain Talk guide examines the relationship between risk and reward over 50 years of sharemarket returns. It aims to help investors understand what is and what is not realistic to expect from their share investments.

What history tells us

History tells us that the sharemarket is a long-term investment vehicle. Over shorter time periods, returns can be volatile – the global financial crisis of 2008/09 demonstrated just how dramatic this volatility can be. While the average return over 30 years to December 2009 was 16.2 per cent, annual returns ranged between -29 per cent and 74.3 per cent.

The good news with sharemarket investing is the longer your investment timeframe the better your chances of riding out the ups and downs and enjoying steady market growth.

Value of $10,000 invested over 30 Years
(to December 2009)



Past performance is not an indication of future performance.
Assumes 100% reinvestment of distributions and does not take into account fees and taxes. Source: Andex Charts Pty Ltd.

50 years – a long investment horizon

For people in their twenties just starting to contribute to superannuation, 50 years would seem like a long investment horizon. The key thing to remember is that it is time in the market that counts. For the 50 years to 31 December 2009, the Australian sharemarket has delivered an average annual return of 11.1 per cent. This average return is above the Australian Securities and Investment Commission's long-term mean annual return expectation of 9 per cent. The following table compares the performance of different asset classes over 5, 10, 20 and 50 years.

Average annual returns for the major asset classes

Period to 31 Dec 2009	Australian shares	International shares	Listed property	International property	Australian bonds	International bonds	Cash
5 years	8.2%	-1.0%	-7.3%	-3.4%	5.7%	7.1%	5.9%
10 years	8.7%	-3.6%	4.1%	7.5%	6.5%	7.9%	5.6%
20 years	9.9%	4.6%	7.8%	n/a	8.9%	9.2%	6.6%
50 years	11.1%	n/a	n/a	n/a	7.9%	n/a	7.9%

Past performance is not an indicator of future performance.
Source: Andex Charts Pty Ltd.

What a difference a decade makes

While long-term historical averages can give some indication of expectations for the future, they are by no means a guarantee. Returns in the future can be higher or lower than those in the past and there is no guarantee you will earn the long-term average annual share price.

When you break sharemarket performance down by decade, returns can vary widely. As the table below shows no two decades have produced the same results. It's important not to forget the significant events that have impacted returns over the last 50 years, some positive, some negative – such as the recent Global Financial Crisis.

Value of $10,000 invested in Australian shares at the start of each decade

1950s	1960s	1970s	1980s	1990s	2000s
$41,543	$37,027	$15,221	$50,892	$28,767	$23,018
15.31% p.a.	13.99% p.a.	4.29% p.a.	17.67% p.a.	11.14% p.a.	8.69% p.a.

Past performance is not an indicator of future performance. Source: Andex Charts Pty Ltd.

What drives sharemarket performance

Investment markets move in cycles, reflecting the underlying strength of the economy, political factors, industry trends and market sentiment. On any given day interest rate and inflation expectations, company profits, dividends, economic growth figures and the rise or fall of our dollar can influence share prices.

Just as powerful are the effects of changes in domestic and international politics and the mood swings of investors. As history tells us, fear and greed can play a significant role in daily market movements. Time and time again unsustainable market prices, propped up by speculation, have come undone when investment fundamentals and common sense have prevailed.

In his *Little Book of Common Sense Investing* Jack Bogle draws on British economist Keynes to explain the long-term investment performance of the sharemarket. "The state of long-term expectation for stocks is a combination of enterprise ('forecasting the prospective yield of assets over their whole life') and speculation ('forecasting the psychology of the market')." The latter refers to the impact of changing price/earnings multiples on stock prices.

Dividends and earnings growth – the keys to market growth

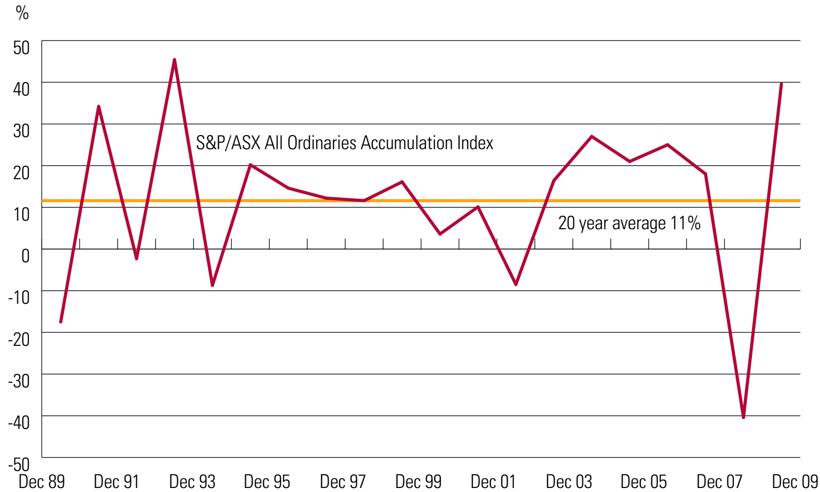
Enterprise as Keynes described is derived from a company's dividend yield and earnings growth and is one of the most fundamental drivers of long-term market growth.
To calculate a share's dividend yield you divide the annual dividend by the current share price and express it as a percentage.

While long-term average dividend yields can provide an indication of expected long-term yields from the sharemarket, actual yields can change dramatically from year to year.
If company profits are not growing at the same rate as the increase in their share price, then the dividend yield may fall. The graphs opposite show total returns and dividend yields of the Australian sharemarket over each of the last 20 years.

Beware of irrational exuberance

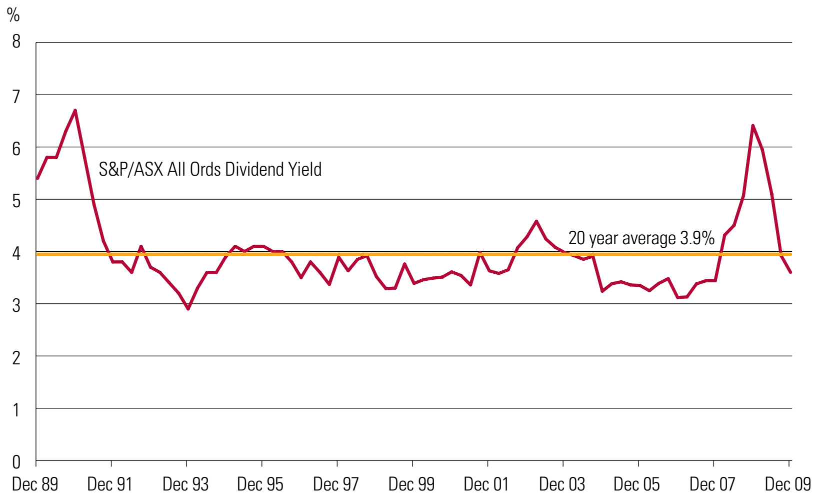
Irrational exuberance is a phrase coined by former Federal Reserve Board Chairman Alan Greenspan three years before the dot-com crash of March 2000. Greenspan was referring to how speculation was inflating asset values during the US technology stock market boom of the late 1990s. The dot-com era had begun with new start-ups emerging almost every day. Many of the start-ups were trading at values far beyond what their balance sheets and business plans warranted. The NASDAQ Composite Index more than tripled in value from late 1998 to March 2000, peaking at 5,048 points, only to fall 64 per cent in the following year. The NASDAQ has failed to gain its previous heights and at the time of writing is trading at less than half its March 2000 high.

Australian shares financial year returns for 20 years
to December 2009



Past performance is not an indicator of future performance. S&P/ASX All Ordinaries Accumulation Index
Assumes 100 per cent reinvestment of distributions. Source: Andex Charts Pty Ltd.

Australian shares dividend yield for 20 years
to December 2009



Past performance is not an indicator of future performance.
S&P/ASX All Ordinaries Index Dividend Yield. Source: Vanguard, using market data.

Market myths and truths

Myth 1: Declining markets are the best time to buy

While declining markets usually recover, it can take time. Some investors see a price drop as an opportunity to buy securities at a discount, while others see it as the start of a deeper downturn.

It is important to keep in mind there is no guarantee that share prices will recover to their previous value. Sometimes, there is a good reason why individual share prices fall, reflecting underlying poor corporate performance.

Predicting the bottom of the market is extremely difficult. That's why many seasoned investors use a dollar cost averaging strategy instead. Rather than investing all their money at once, they drip feed it into the market so they can average out share prices over time. This has the effect of averaging out market fluctuations.

Myth 2: Market timing beats buy and hold

Intuition tells us that the best time to buy is when prices are down, and the best time to sell is when prices are up. Timing the markets for the best time to invest is easier said than done. Even professional fund managers find it difficult to continuously time the markets for the right time to invest.

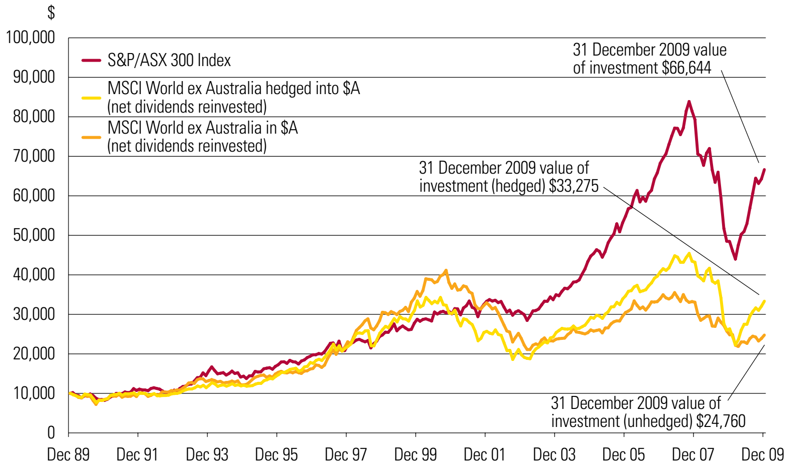
Sharemarkets are unpredictable and if you try to time the market, you have to get two important decisions right: when to get out and when to get back in. You may miss the recovery completely and have to pay a higher price to get back into the market. You also risk missing out on market growth.

Myth 3: Sell when the market drops

Investors with a short-term view of the sharemarket are most likely to sell when the market starts to fall. The fight or flight response is a natural human reaction to panic. Unfortunately, fleeing the sharemarket when things turn sour crystallises your losses. It can be costly in terms of performance, transaction costs and capital gains tax – something investors often overlook. It also means you may be out of the market when it recovers and miss out on future market growth.

The power of long-term investing

Growth of $10,000 invested in the Australian and International sharemarket for 20 years to December 2009



Past performance is not an indicator of future performance. Index returns do not take into account fund fees and tax.

Source: Vanguard, using market data.

Truth 1: It's time in the market, not timing the market

Long-term investing isn't about chasing the hottest performing stocks. It's about taking a long-term view and staying the course. It won't protect you from market downturns, but it ensures you are "in the market" during times of growth.

With hindsight, many investors who play the game of market timing realise just how much better off they would have been simply riding things out. While the last decade has been tumultuous on the global economic and political front, the Australian market has proved its resilience. The GFC, the US invasion of Iraq, September 11 terrorist attacks, dot-com crash, Asian financial crisis and rising world oil prices have all provided short-term setbacks.

The pace of market recovery following the lowest ebb of the GFC was remarkable – with a market rebound of more than 60 per cent in April 2010 from a low of -48.3 per cent in March 2009. Investors who may have pulled out of the market when the going got tough may have been disappointed to miss the subsequent rebound, proving the folly of trying to time a volatile market.

"I do not know anybody who has done it successfully and consistently, nor anybody who knows anybody who has done it successfully and consistently."
Jack Bogle, Founder, The Vanguard Group Inc., on market timing

Truth 2: Sharemarkets can be volatile

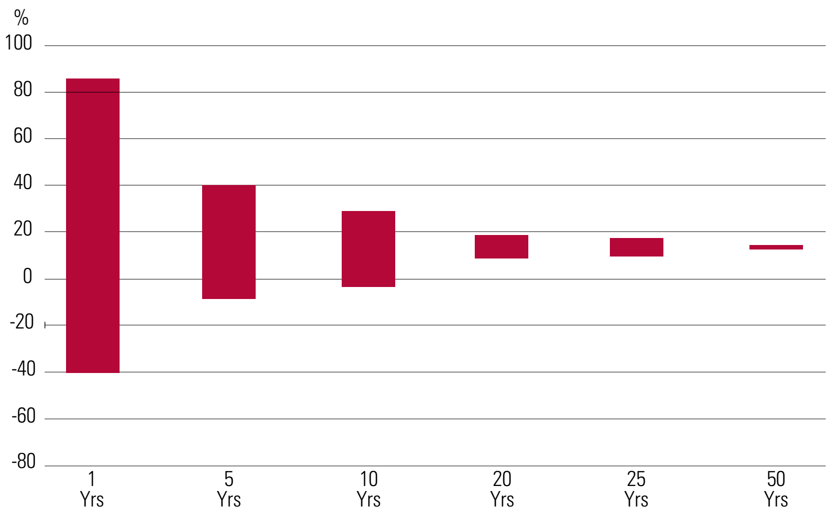
Volatility is the major risk of investing in shares. However, it's one many investors overlook during periods of positive returns. Time greatly reduces but does not eliminate the volatility in returns from shares.

The chart below shows the range of returns for the Australian sharemarket over different investment timeframes.

Over time, the ups and downs of investment markets tend to even out and the gap between the highest and lowest returns closes. This is why it is important to consider your investment timeframe when choosing your investments.

Volatility of Australian shares: range of returns 1950 – 2009

to December 2009



Past performance is not an indicator of future performance. Index returns do not take account of fund fees.

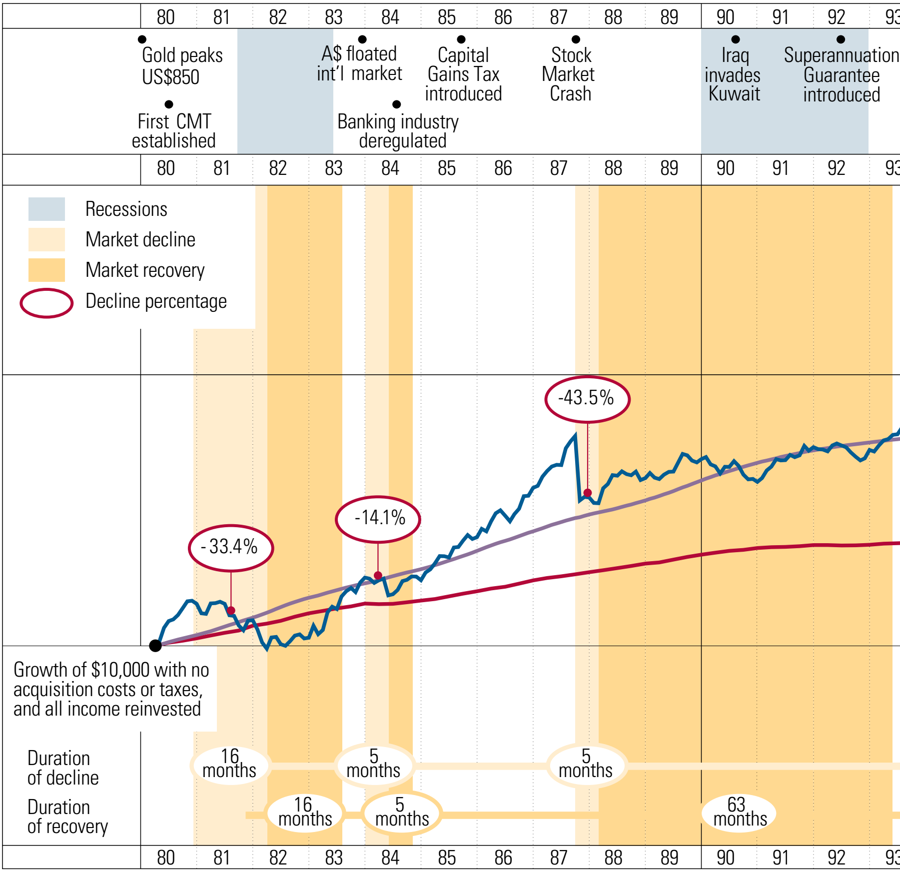
Source: Vanguard, using market data.

Truth 3: Bear markets are part of investing

Although there is no definitive definition, a bear market is generally defined as a decline in the sharemarket of more than 20 per cent over two consecutive months or longer. Bear markets are not unique to shares, they can also occur in bond and property markets. Over the past 50 years, the Australian sharemarket has experienced a bear market, on average, once every five years. Although no one can reliably predict the timing of bear markets, or bull markets for that matter, investors need to be aware of the extent to which share prices can fall. The big danger of bear markets is that

It's time in the market that counts

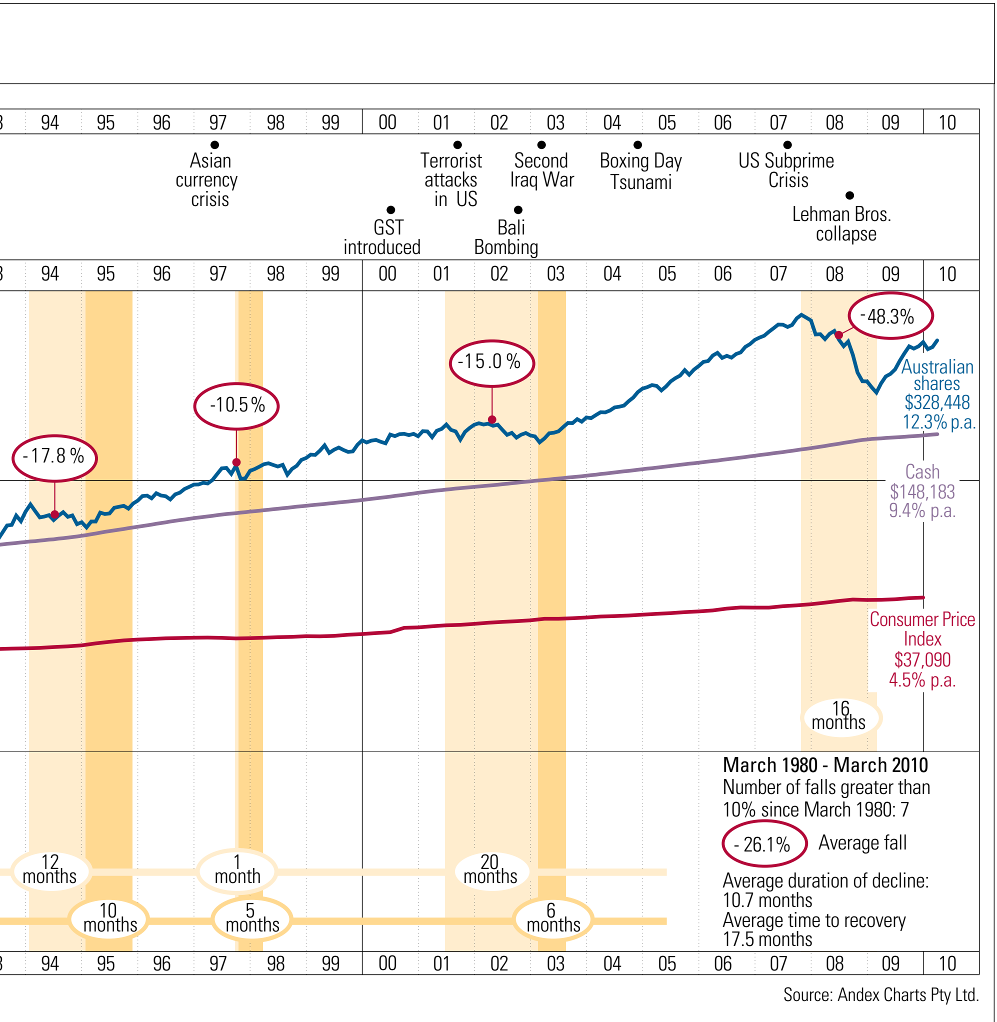
Australian share market volatility 1980–2010



This graph shows downturns greater than 10% and the time it has taken the market to recover.

investors will panic and sell at or near the bottom of the downturn. Many investors did just that in the market decline of late 1987.

The graph below shows the movement of the Australian sharemarket over the past 30 years and indicates where the market has fallen greater than 10 per cent – which has happened seven times since 1980. The chart provides some useful insights and historical information on falls and recoveries and how an investment of $10,000 in the Australian share market has fared over the 30 year period.



Source: Andex Charts Pty Ltd.

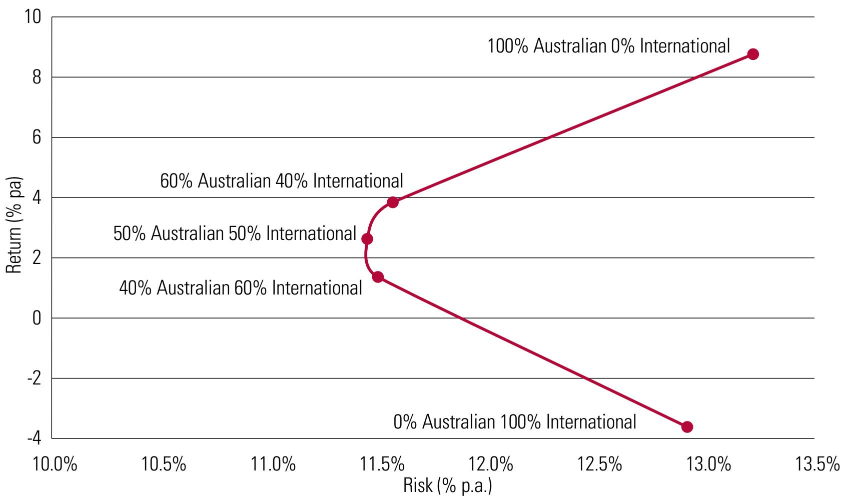
Investing overseas

Investing internationally can increase your diversification further and give access to industries and companies not available in Australia. After all, Australia represents less than 3 per cent of the total world sharemarket.

The Australian market is highly concentrated with a large representation in the financial services and resource sectors. The top 10 Australian companies make up more than 40 per cent of S&P/ASX 300 Index, with three out of the top five companies in the financials sector.

Modern portfolio theory is a theory of investment which tries to maximise return and minimise risk by carefully choosing different assets. The graph below shows how diversifying your portfolio and including an allocation to international shares can help improve your return potential and potentially lower your risk.

Australian and international shares: risk and return



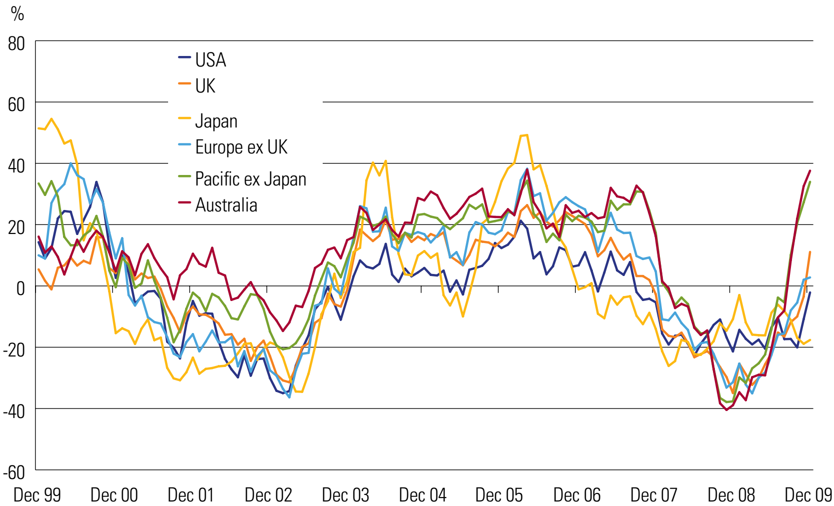
Past performance is not an indicator of future performance. Index returns do not take into account fund fees, expenses and tax. Note: we define risk as the standard deviation of returns

Source: Vanguard, using market data.

The other benefit of investing internationally, is that investment markets tend to move in different cycles, driven by their economic health, and other factors. The graph below shows the annual returns of major international and Australian equity markets over the past 10 years.

A world of opportunity: annual returns over the last 10 years

(to December 2009)



Past performance is not an indicator of future performance. Index returns do not take into account fund fees, expenses and tax.

Source: Vanguard, using market data

Managing the risks

You can never be certain of the best time to invest. What you can do is be aware of the risks so you are prepared for volatile times in the markets.

If history is anything to go by, learning not to panic during market downturns and keeping a long-term perspective are two of the most valuable investment lessons you can learn.

Although risk is unavoidable when investing, one of the greatest risks can be not investing at all. Rising prices due to inflation can erode the real value, or purchasing power of your money.

Tips for volatile times and beyond

Know what type of investor you are

Understanding your attitude to risk and return is arguably the most important insight you can gain when investing.

You might be attracted to the prospect of great performance, but how much risk are you willing to take to achieve it? Are you likely to get caught up in market hype when markets are performing well, only to pull out when things turn sour?

Sharemarket investors can expect a negative return once in every five years. Share investors need to look beyond annual performance data and focus on the long-term (five years plus). If you have trouble doing this perhaps you need to check that your investment strategy suits your risk profile.

A long-term investment strategy should be based on your objectives, time horizon, risk tolerance and personal financial circumstances, and not determined by short-term market performance.

Keep your balance

Spreading your money across a range of investments such as shares, property, bonds and cash, is one of the best ways to reduce your exposure to market risk. This way you are not relying on the returns of a single class of investment. Finding the right balance is a matter of weighing your investment objectives, risk/return profile and investment time-frame.

"My advice to investors is to ignore the short-term noise of the emotions reflected in our financial markets and focus on the productive long-term economics of our corporate businesses."

John C. Bogle on investing and emotions in his *Little Book of Common Sense Investing*.

Tune out market 'noise'

It is human nature, at the first sign of trouble, to become nervous and want to save your investment from falling in value. Market downswings can cause even resilient investors to have second thoughts. One factor you need to get used to, is that markets run in irregular cycles and good and bad markets come and go.

Reassure yourself that you are investing for long-term growth rather than trying to avoid short-term losses.

Over longer time periods, share prices are mainly determined by fundamentals such as corporate earnings, dividends and interest rates on competing investments.

Time in the market is everything

When it comes to investing, one of your greatest allies is time. It has a moderating effect on sharemarket risk, and the longer you hold an investment, the more likely you are to enjoy market growth.

Regardless of how high share prices are one day, it is no guarantee of their price the next day. If you have a short-term time horizon, such as five years or less, sharemarket investing might be not be your best investment option.

Invest often

Timing the markets for the best time to invest is easier said than done, which is why many investors use a dollar cost averaging strategy. With this strategy, rather than investing in a single lump sum, you drip feed your money into the market in smaller regular amounts. This strategy has the tendency to average out market fluctuations over time.

Investing in the sharemarket for less

For many investors, buying and holding a diversified portfolio of investments is an effective strategy over the long run. In the 1996 Berkshire Hathaway Annual Report legendary investor Warren Buffett wrote, "Most investors, both institutional and individual, will find that the best way to own common stocks (shares) is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) of the great majority of investment professionals."

One way to gain broad exposure to the sharemarket, both local and overseas, is through an index fund. Index fund managers aim to track the performance of a market index by investing in all or a representative sample of the securities in the index. A benchmark index measures the performance of a basket of securities. For example, the S&P/ASX 300 Index measures the performance of about 300 companies listed on the Australian Stock Exchange.

Because index funds usually invest in all or most of the securities in the index, they provide diversification, which means lower risk.

By adopting a 'buy-and-hold' approach the cost of investing can be significantly reduced over time and lead to better returns in the long term, especially on an after-tax basis.

Unlike active fund managers, index fund managers don't try to outperform the market. Rather, they let markets do their work over the long term.

The indexing pioneers

Vanguard pioneered the concept of indexing, introducing the first retail index fund in the US in 1976. Since then, The Vanguard Group, Inc. has grown into one of the world's largest and most respected investment management companies. Vanguard now has global presence with offices in the US, Melbourne, Sydney, Brussels, Tokyo and Singapore. In Australia, Vanguard has been helping investors meet their long-term financial goals with low-cost indexing solutions for more than 12 years.

Vanguard's range of managed funds and ETFs

Vanguard offers a complete range of managed funds across all asset classes that can be used as a diversified standalone portfolio solution, or in conjunction with active funds as part of a core-satellite approach.

Sector Funds

- Cash
- Fixed Interest
- Australian Shares
- Property
- International Shares

Diversified Funds

- Conservative
- Balanced
- Growth
- High Growth

Exchange Traded Funds

- Australian Shares
- Australian Property
- US Shares
- International Shares

Data sources

Data is calculated using returns of an index for each asset class which assumes all income is reinvested. Unless otherwise stated, performance data is as at 31 December 2009. To view currrent performance data, visit our website www.vanguard.com.au

Andex indices used are:

Australian Shares

- Since Dec 1980, S&P/ASX All Ordinaries Accumulation Index
- From Dec 1969 to December 1980, MSCI Australia Gross Total Return Index
- Prior index returns calculated by Global Financial Data

International Shares

- MSCI World ex-Australia Total Return Index – net dividends reinvested

Listed Property

- S&P/ASX A-REIT Accumulation Index

Australian Bonds

- Since Sep 1989, UBS Composite Bond Index
- From Dec 1976 to Sep 1989, Commonwealth Bank Bond Accumulation Index
- Prior index returns have been calculated using data from the Reserve Bank of Australia

Cash

- Since March 1987, UBS Australian Bank Bill Index
- Prior index returns calculated using data from the Reserve Bank of Australia

Vanguard indicies used are:

Australian Shares (Dividend Yield Chart)

- S&P/ASX All Ordinaries Accumulation Index

Australian Shares (All other charts)

- S&P/ASX All Ordinaries Accumulation Index to 31/03/00
- S&P/ASX 300 Accumulation Index from 31/03/00

International Shares

- MSCIWorld ex-Australia Total Return Index - net dividends reinvested

Cash

- UBS Australian Bank Bill Index

International Shares (Regional indices)

- MSCI USA Index in $A
- MSCI UK Index in $A
- MSCI Japan Index in $A
- MSCI Europe ex-UK Index in $A
- MSCI Pacific ex-Japan Index in $A

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The indexing specialist > vanguard.com.au > 1300 655 101

Note: All currency is in Australian dollars unless otherwise stated. Unless otherwise stated data sources are Vanguard, using market data. Performance data is up to date as of 31 December 2009. To view current performance data, visit our website www.vanguard.com.au

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