

Surviving a market crisis – Why staying in the markets is the best way to go

October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February. *–Mark Twain*

The credit crisis of 2008 is testing the mettle of even the most seasoned investors. With global financial markets demonstrating some of the highest levels of anxiety we've seen since the Asian currency crisis of 1997, many investors are fearful about the savings they have invested and wonder how this will affect their long-term financial plans.

Context is everything

To help place some context on today's markets, it always helps to turn to history to act as our guide. The following chart illustrates a 25 year period where the S&P/TSX Composite Index has experienced a number of sharp downturns. The chart not only illustrates the depth of each downturn in percentage terms, it also illustrates the number of months it took for the S&P/TSX to return to its former level, and the annualized return required in order to do so.

S&P/TSX Market Corrections & crashes: 1983 - present

Period	S&P/TSX Return (%)	Time Period to Recover (months)	Post Annualized S&P/TSX Return (%)
Q4'83 – Q3'84	- 16	6	47
Q3'87 – Q4'87	- 26	21	19
Q4'89 – Q4'90*	-23	34	11
Q1'94 – Q2'94	-12	13	14
Q2'96 – Q3'96	-6	2	53
Q3'97 – Q4'97	-8	3	41
Q2'98 – Q3'98	-28	16	37
Q3'00 – Q4'02	-45	39	20
Q3'06 – Q3'06	-5	4	25
Q3'07 – Q1'08	-13	4	44

For illustration purposes only.

*Period represents slow correction lasting 4 quarters. Source: MFC Global Investment Management



What stands out in this chart is the post annualized returns that follow a market downturn. If an investor were to sell their shares in an effort to preserve capital during the worst days of each downturn, they would likely miss out on some exceptional returns once the markets recovered.

Emotions: An investor’s worst enemy

The intense emotions that accompany a severe market downturn are certainly understandable. After all, why would anyone not want to avoid a loss if they could? When we boil these emotions down, however, we begin to realize that investing behaviour is largely governed by two dominant emotions: fear and greed. And when you think about it, you’ll realize that neither of these emotions form a sound basis for making rational decisions.

An extensive research report entitled *QAIB 2007: Quantitative Analysis of Investor Behaviour* undertaken by Dalbar Inc., a company that specializes in analyzing the behaviour of mutual fund investors, supports this claim. One of the key findings in the report shows that as markets rise, investors pour cash into mutual funds. And sure enough, a selling frenzy begins shortly after a market decline¹. But when you look at this finding objectively, you quickly realize that the average mutual fund investor is buying when prices are high and selling when prices are low – which is exactly the opposite of what a successful investment strategy requires.

The proof is in the returns

How much does investor behaviour affect returns? In the following chart, we can see that over the last 20 years, the average mutual fund investor has lagged the return of the S&P 500 Index by a considerable margin. While the S&P 500 has increased in value a respectable 11.8 per cent per year on an annualized basis, the average mutual fund investor has only obtained a 4.3 per cent return over the period. If we turn to the five year annualized return figure, we can see that the average mutual fund investor was able to reverse this trend with a respectful 7.1 per cent return, which compares favourably to the S&P 500 Index return of 6.2 per cent.

Annualized Returns for:	1 year (%)	3 years (%)	5 years (%)	10 years (%)	20 years (%)
Average Equity Fund investor	14.7	11.3	7.1	6.2	4.3
S&P 500	15.8	10.4	6.2	8.4	11.8
Inflation	2.0	2.8	2.1	2.2	3.0

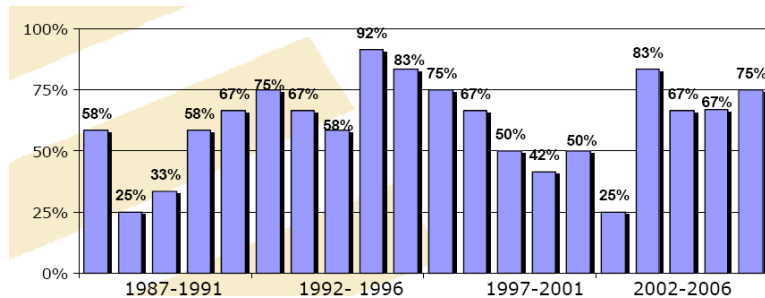
For illustration purposes only. Source: QAIB 2007, pg 20.

¹Quantitative Analysis of Investor Behavior (QAIB), 2007 DALBAR, Inc.



These numbers highlight an important finding in behavioural finance: Investors tend to hold onto their investments during bull markets, such as the one we experienced from 2002 - 2007, but sell when they anticipate a loss. The problem is many investors sell their investments after the markets have already fallen and remain out of the markets when they eventually rebound.²

The proof of this finding is found in the following graph. The Dalbar study presents an interesting evaluation of investor behaviour called the “guess right ratio.” In a nutshell, the guess right ratio measures how often the average equity investor “guesses” the direction of the market correctly. What the study found was that average mutual fund investor made good calls during rising equity markets (1992, 1995, 1996, 1997 and 2003, 2005, 2006) but investors made most of their mistakes after down turns in the markets (1988, 1989, and 2002). Their conclusion was that these mistakes occur because investors are driven by the fear that the markets will not recover.³



Source: QAIB 2007, pg 9.

For the majority of investors, it could be better to hold the course

While it is impossible to provide a “one size fits all” recommendation to every investor, these figures help illustrate why for many, the best course of action may be to take no action at all. If you have a mid to long-term investment horizon, you may want to consider investing excess capital using a dollar-cost-averaging investment strategy, since stock prices are now “cheap” by historical standards. For investors with shorter time horizons, we suggest you speak to your advisor about whether there is a need to make adjustments to your current financial plan.

² Quantitative Analysis of Investor Behavior (QAIB), 2007 DALBAR, Inc.

³ Quantitative Analysis of Investor Behavior (QAIB), 2007 DALBAR, Inc.

For more information, please contact your advisor.

