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It's the time you spend in the market that counts

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Over the last 12 months global market volatility has risen and along with it investor irrationality. It all began with a collapse in the US housing market and ended up in a global credit crunch which has seen many of the largest and oldest independent financial institutions collapse.

Amongst other things, the credit crisis has been the catalyst for a meaningful slowdown in global growth and together with rising inflation it's been difficult for central banks to protect economies from potential recession. While the Fed and other major central banks attempt to provide liquidity to the financial markets to avert a financial system collapse, inflation targeting remains one of their major concerns to enable them to prevent economies falling into stagflation.

Although SA's exposure to the subprime crisis has been limited so far, negative sentiment from global investment markets has had a direct impact on our market as we continue to see offshore investors selling out of emerging markets like SA.

The domestic economic outlook has also deteriorated. The SARB's inflation targeting has led to continued rate hikes (totaling 500bps over the last two years) in an attempt to bring inflation back into the 3-6% band. Rising oil and food prices globally has been the major contributor to the unexpected spike in SA's inflation, with Eskom's large electricity tariff increase also coming through in recent months, leaving inflation at a record high of 13.4% y/y. The sharp depreciation in the Rand since the beginning of 2008 will also contribute to inflation going forward.

It's been a torrid market and in hindsight every investor probably wishes they'd moved into cash at least a year ago. In fact, over the last 6 months, record amounts of money have been moved into money market accounts as investors seek safe havens. Investors seem to be acting largely on emotion and investment decisions made emotionally generally tend to be wrong. Investors also tend to go against common investment theory and instead of buying cheap and selling more expensive, they sell cheap (out of panic) and buy back more expensively.

Timing the market is exactly where the problem lies. If you sold into cash and were capable of calling the bottom of the market, this approach would definitely have worked. However, historically when markets turn positive and rally, much of the gains are made in the first three months, a period during which most investors are waiting for confirmation that the rally is sustainable. They inevitably miss the rally.

So what should investors be doing? There is unfortunately not much to do at this stage and investors should definitely not be considering a fundamental restructuring of their portfolios. Time for restructuring portfolios is when markets are calm and not during excessive market volatility.

Inflation moves through cycles and has a very marked impact on asset class returns. High inflation has historically been a problem in SA. A good investment should be able to provide you with positive real returns (after inflation returns) over all periods of time. Looking at the table below, positive real returns were generated for all asset classes during times of moderate or low inflation. In times of higher inflation however equities were the only asset class able to generate positive real returns.

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Asset class returns during distinct periods of domestic inflation from 1900-2008:

Average nominal returns	# Periods	Equities	Bonds	Cash	Inflation
Deflation	17	7.4%	4.6%	2.8%	-4.4%
Low Inflation	19	11.6%	5.6%	3.1%	1.1%
Moderate Inflation	34	13.7%	5.9%	4.3%	4.1%
High Inflation	38	18.3%	9.3%	10.6%	11.9%
Average real returns					
Deflation	17	12.3%	9.4%	7.8%	
Low Inflation	19	10.4%	4.5%	2.0%	
Moderate Inflation	34	9.2%	1.7%	0.2%	
High Inflation	38	5.8%	-2.2%	-1.1%	

Source: Peregrine IQ

Due to the nature of equities investors often experience unwanted short term volatility similar to current market conditions. Investment theory tells us that it is very difficult to time the markets, so does the time you spend in the market make the difference instead?

If you compare rolling annualized real returns for the different asset classes over 1,3,5 & 10 years you'll be amazed to see how difficult it has been to beat inflation and thereby generate positive real returns. Equities once again came out on top and was the only asset class where the number of negative real return periods decreased significantly as the time in the market increased. The probability of equities delivering positive real returns increases over time while the probability for cash and bonds to beat inflation remain consistent over time and hovers around 55-60%.

Negative real return periods from 1900-2008:

Rolling annualized real returns	# Negative real return periods in equities	# Negative real return periods in bonds	# Negative real return periods in cash
1 year	41	43	38
3 years	26	39	40
5 years	16	40	n/a
10 years	6	37	n/a

Source: Peregrine IQ

With bad news flooding the markets every day it's definitely not been easy for investors to have weathered the storm. There is indeed a lot of risk during times like this, but one should never forget that significant investment opportunities are starting to emerge in the markets and portfolio managers will definitely seize these opportunities to enhance future fund performance. You may decide to sit on the side until it feels more comfortable to invest in the market again, but once you realize that it may no longer be profitable to do so, you could have missed a significant portion of the market recovery.

History has repeatedly shown that just when things seem at their worst it is exactly when you should be buying, just as you should sell when it appears as if nothing can go wrong and this is exactly what your portfolio manager is doing. At the end of the day, it's the time you spend in the market that really counts towards your portfolio's performance.

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