

# Take Note

## HOW TO BEHAVE DURING PERIODS OF MARKET VOLATILITY



Over the three years to the end of April 2006 the UK equity market has returned nearly 80%. More recently equity markets have entered a period of uncertainty. For example, the FTSE All-Share declined by almost 8% over the month between 10<sup>th</sup> May and 12<sup>th</sup> June. These types of market movements, though uncomfortable, are a normal part of equity market behaviour. Equities provide higher returns over the long-term because of this short term uncertainty and investors need to resist the natural urge to sell and need to remain invested if they want to capture these higher long-term returns that equities offer.

This document aims to provide some guidance on how investors should behave during periods of market volatility. It also provides a background to the factors that led to the market sell-off.

In summary, our advice to investors concerned about the recent market declines can be summed up in three sentences:

- **Equity market volatility is normal.** Equities, and other “risky” assets, provide higher expected long term returns than savings deposits and government bonds because they have a higher degree of short-term uncertainty. In effect, the “premium” paid for the higher expected returns is volatility. Therefore, if equities were less volatile, and their returns more predictable, then the expected long-term returns would also be significantly lower.
- **Changing your investment strategy in response to short-term market conditions is dangerous.** Investors reacting to market events risk selling after periods of negative returns, and chasing performance. This is a recipe for “buy high, sell low” investing. Investors should base their investment strategy on their objectives, time horizon and risk tolerance, not the behaviour of markets over the past few weeks. Investors who succumb to the temptation to flee when markets are going down risk paying the price of higher returns - volatility - but missing out on the rewards.

- **The best form of risk control is diversification.** We advise investors to maintain portfolios diversified across multiple asset classes, and across multiple managers, sectors, styles and securities. A well diversified portfolio will not decline in value as far or as fast as the worst performing asset class.

### What are the causes of May's declines?

The equity market rally that started in March of 2003 has been notable for the steadiness of gains. Volatility has been relatively low and, more recently, some investors have been willing to increase their exposure to “riskier” assets in a quest to capture greater returns.

Over the past few weeks, however, many market participants have taken fright and rapidly reduced their exposure to these riskier assets. As a result, investments that had performed very well in the past 12 months have suffered sharp losses. An example of this has been the rapid retreat of commodity prices such as copper which having risen 98% in the first four months of 2006 then retreated approximately 10% since then.

However, nothing has fundamentally changed in May. The only economic “surprise” – higher-than-expected inflation in the US – simply extended losses rather than triggering them. There is also no evidence of an economic slowdown. The OECD

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(Organisation for Economic Co-operation and Development) in its twice yearly economic report published on 23<sup>rd</sup> May predicting growth for OECD economies at 3.1% in 2006 and 2.9% in 2007, with figures of 2.4% and 2.9% for the UK. These are similar to GDP growth over the past few years.

While it's always difficult to know for sure why markets behave in a particular manner, many commentators have cited two main factors as contributing to the recent declines:

- **Mixed guidance from the US Federal Reserve** (Fed) has unnerved investors, many of whom feel that inflation is not under control and the Fed will have to keep raising US interest rates.
- **Global inflation fears are beginning to emerge**, especially given that the four leading central banks all now appear to be in an interest rate-tightening phase.

**How should investors react to this volatility?**

**1. Keep things in perspective.** The table below shows both recent performance and over longer time periods. Whilst one month figures are negative, the one year figures remain positive for all equities.

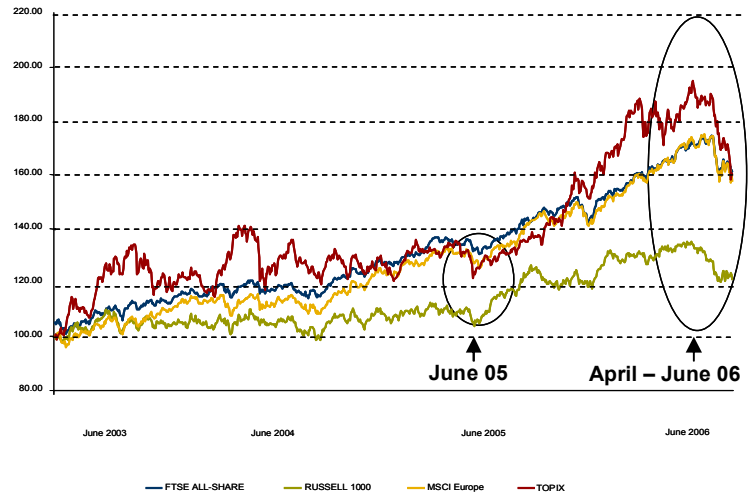
**Performance to mid June 2006**

	1 Month*	1 YR	3 YRS
<b>World</b>			
MSCI World (US\$)	-8.2%	11.4	37.4
<b>US</b>			
Russell 1000 (US\$)	-5.4%	4.1	21.0
<b>UK</b>			
FTSE All-Share (£)	-7.9%	17.1	55.3
<b>Europe</b>			
MSCI Europe (€)	-9.6%	17.7	56.8
<b>Japan</b>			
Topix (¥)	-14.3%	24.1	66.4
<b>Asia</b>			
MSCI AC AsPac Free ex-Japan (US\$)	-13.3%	17.8	81.6
<b>Emerging Markets</b>			
MSCI EM Free (US\$)	-19.8%	26.5	108.4

\* (10<sup>th</sup> May 2006 – 12<sup>th</sup> June 2006)  
 Source: Lipper. All total return indices. (not annualised)

Below is a chart of market performance since the end of the last bear market in March 2003. Last June (highlighted), world equity investors turned briefly bearish on the back of concerns over the sustainability of global growth and this in turn led to a flight to safety as equities were shunned for lower returning assets. However, this appears as a minor blip when viewed over an appropriate time horizon and, in this case, preceded further strong gains.

**Markets since June 2003**



Source: Russell.

**2. Don't succumb to temptation.** When confronting negative markets, investors often assume that "something has gone wrong" and believe that they need to "do something" to fix it.

This, combined with the emotional pain of falling valuations, can be a powerful force. In these situations not taking action is frequently the best course to take.

A long-term strategic asset allocation designed to capture the returns of investment markets and implemented through a properly diversified portfolio is designed to control the extremes of market volatility, while maintaining appropriate market exposure.

When investors succumb to short term fears and sell, they lock in losses and forfeit the ability to participate in future market upside.

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### 3. Confirm that their risk tolerance is appropriate.

When markets fall many investors feel that either markets have got more risky or their risk tolerance has decreased. In reality it is unlikely that either of these events has occurred. What investors are experiencing is a change in their short-term perception of risk. Investment markets are always risky, while investor's risk tolerance changes gradually, if at all.

Asset allocation decisions should be based on the investor's circumstances, not market conditions. At these times an investor should reconfirm, perhaps with the assistance of their advisor, if the return they are targeting remains appropriate and whether the risk that this involves is still tolerable.

If the investor does want to reduce their risk tolerance, they should clearly understand that the expected return of their portfolio will also be significantly reduced which could cause them to miss their long-term objectives.

For those investors that do make changes now, we would advise against changing asset allocation again when equity markets recover as this would be falling into the trap of chasing markets.

### Conclusion

Periods of volatility are unnerving for everyone. The best investors are those able to take a dispassionate view as events unfold.

By reconfirming their investment principles and objectives, investors should be able to filter out a lot of the "noise" that, if heeded, can disrupt their long-term financial plan and subsequent success in meeting their objectives.

#### Summary

##### Advice to investors

- Equity market volatility is normal
- Changing your investment strategy in response to short-term market conditions is dangerous
- The best form of risk control is diversification

##### How should investors react to market volatility?

- Keep things in perspective
- Don't succumb to temptation
- Confirm that their risk tolerance is appropriate

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