

Investment Tutor Learning Lessons from the Past

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In the light of the recent rollercoaster ride in the equity markets, Chris Wagstaff, Head of Investment Training and Development at Aviva Investors, puts the market turmoil into perspective and considers whether equities still merit a prominent role in the asset mix.

The textbooks tell us that, in a world of total certainty, equity prices should continually reflect their fair, or intrinsic, value, based on the projected worth of company profits and dividends, which, in turn, are heavily dependent upon the performance of the underlying economy. By definition, equity prices should not exhibit excessive bouts of volatility and certainly shouldn't under or overshoot this fair value. However, in the real world this is exactly what they do. Indeed, whilst in the long run they follow an upward trajectory, equity markets rarely move up or down in a linear fashion for any length of time. Rather they gyrate en route to their chosen destination as investors fret about what the future holds. In short, market volatility is part and parcel of investing in equities.

When complacency pervades the market and hope and expectation have triumphed over fear, volatility, or "vol" in market parlance, is uncharacteristically low as investors treat equities as a one way bet. However, when risk adversity and fear dominate, as they have done in recent months, the reverse is true. Markets become hesitant and volatility moves towards or beyond historical norms, often in a dramatic fashion.

Volatility is typically tracked by the, so-called, VIX index, often referred to as the "fear gauge", as it acts as a barometer of the market's appetite for risky assets, such as equities. Indeed, the VIX index shot up in late January to levels not seen since the inflection point of March 2003, reflecting the fear and uncertainty that currently surrounds the ability of the US economy to keep its head above water and related credit crunch concerns. Crucially, whilst both adversely affect the ability of companies to sustainably generate what have been record high profits - profits that ultimately determine the value of individual stocks and equity markets - the resulting market movements have perhaps been overdone. Indeed, if one looks at the fundamentals, just before January's turmoil, US and UK share prices were hovering around their previous highs of March 2000. However, company profits since then had more than doubled in the UK and were up 70% in the US.

That said, market fundamentals rarely win through in the short term: what matters more is sentiment, a key influencer of which is the media. After all, investor decision making is driven more by intuition and a superficial analysis and extrapolation of recent data, of the type typically found in the media, than by a detached, unbiased and in-depth evaluation of the more salient facts and figures. In particular, sentiment is heavily influenced by media coverage of notable stock market anniversaries, typically those in which markets



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fell dramatically (markets succumbing to gravitational forces are unsurprisingly more newsworthy than those that appear to defy gravity) and the making of not wholly accurate comparisons of current events with those of the past. October is the perennial favourite for this coverage as without fail investors are not only reminded of the 1929 (28 and 29 October) and 1987 (19 October) crashes but the, more recent, October low points of the 1997 Asian crisis (27 October) and dot.com fallout (9 October 2002). Despite the fact that markets don't work to timetables, a not untypical response by investors to coverage of previous episodes of mass selling is, well, to sell. Unsurprisingly, the history books tell us that periods of excessive volatility represent good long run investment opportunities.

Market volatility can also be driven by the balance between positive and negative stories appearing in the press and the repeated use of superlatives and emotive words. The cumulative effect of continually being bombarded with words such as "recession" can have a marked effect on the market's psyche: the more you see it, the more you believe it. In addition, market movements can be made more pronounced on the back of reports that personify the market rather than treating it as an inanimate object. If, for instance, the Outer Mongolian equity market is reported to have "leapt ahead" rather than to have simply "risen by 5%", the chances are that the market may well continue to power ahead given that we are wired to associate animated activity with motion, power and persistence. As philosopher John Paul Sartre once said: "words are loaded pistols."

However, the question remains whether equities, given their inherent volatility, deserve such a prominent role in the asset mix of most defined benefit pension schemes. On the face of it, probably not, as this volatility allied to equity movements not being closely correlated to those of bonds, means that in an IAS 19 driven world equities are generally a poor match for a pension scheme's bond-like liabilities. However, one cannot ignore the fact that in the long run, investors have been handsomely rewarded for assuming equity risk, principally through the compounding effect of reinvesting dividends. Indeed, historically the actual return on equities has far exceeded their prospective return and over the longer run, not only have they outperformed bonds by a not inconsiderable margin but have also kept ahead of price and wage inflation. For all these reasons, equities have acted as a good long term hedge against many of the risks that reside within pension schemes and, dare I say it, a good match, in the real world, for longer dated liabilities. Whether they will continue to do so is, of course, the big imponderable.

The opinions expressed are those of Aviva Investors as at 7 February 2008.

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