

# Realistic sharemarket expectations

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## 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, and as this Plain Talk® guide will demonstrate, it 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.

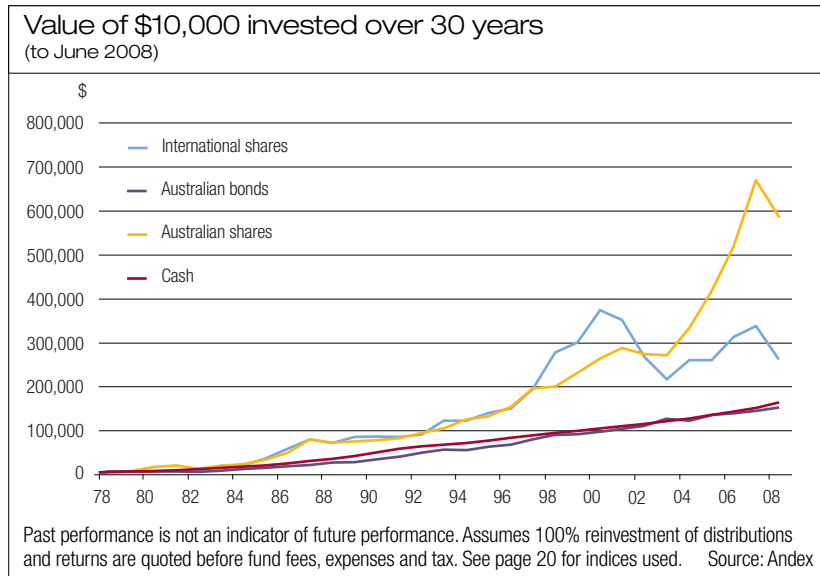
While past performance is no guarantee of future performance, this Plain Talk guide examines the relationship between risk and reward over 50 years of sharemarket returns. It aims to help investors understand what is and what isn't realistic to expect from their share investments.



## What history tells us

History tells us that the sharemarket is a long-term investment vehicle. Over shorter time periods, returns can be volatile. While the average return over 30 years to June 2008 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.



### 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 30 June 2008, the Australian sharemarket has delivered an average annual return of 12.2 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.

Period to 30 June 2008	Aust shares	Int'l shares	Listed property	Int'l property	Aust bonds	Int'l bonds	Cash
5 years	16.8%	4.0%	5.5%	7.3%	4.4%	6.1%	6.1%
10 years	11.3%	-0.5%	8.5%	7.9%	5.5%	7.0%	5.7%
20 years	10.8%	6.5%	9.8%	n/a	8.9%	9.7%	7.5%
50 years	12.2%	11.5%	n/a	n/a	7.7%	n/a	7.8%

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

### 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, although returns over the last two decades have been more stable than the previous three. It's important not to forget the significant events that have impacted returns over the last 50 years, some positive, some negative – financial deregulation, floating of the Australian dollar, Banana Republic days and the OPEC oil crisis to name a few.

	Fifties	Sixties	Seventies	Eighties	Nineties	Noughties
% return p.a.	15.31%	13.99%	4.29%	17.67%	11.14%	10.55%
Value of \$10,000 invested	\$41,543	\$37,027	\$15,221	\$50,892	\$28,767	\$23,454

Index returns are quoted before fund fees, expenses and tax. Assumes 100% reinvestment of distributions. Past performance is not an indicator of future performance. Note: Each investment is for ten years except for the Noughties calculation, which is based on data from 31 December 1999 to 30 June 2008. Source: Andex

## 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* John C. 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

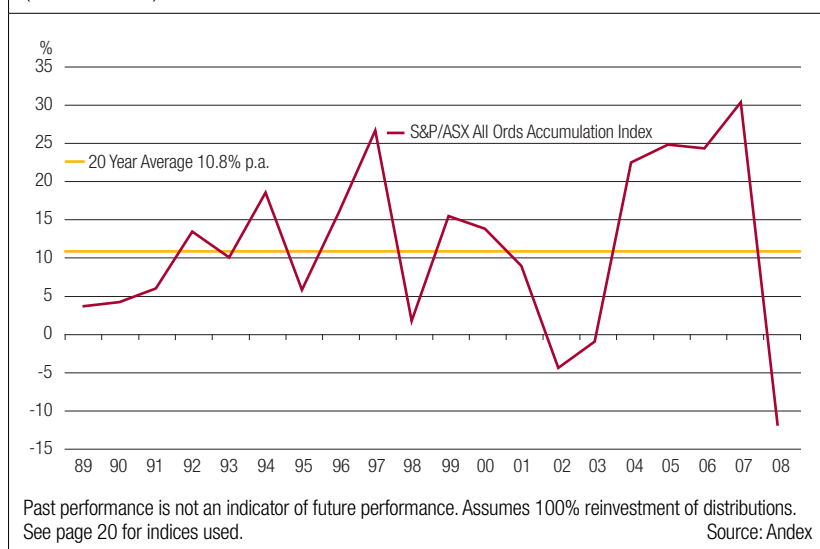
*Enterprise* as Keynes described is derived from a company’s dividend yield and earnings growth and is one of the most fundamental drivers of long-term market growth. To calculate a share’s dividend yield you divide the annual dividend by the current share price and express it as a percentage.

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.

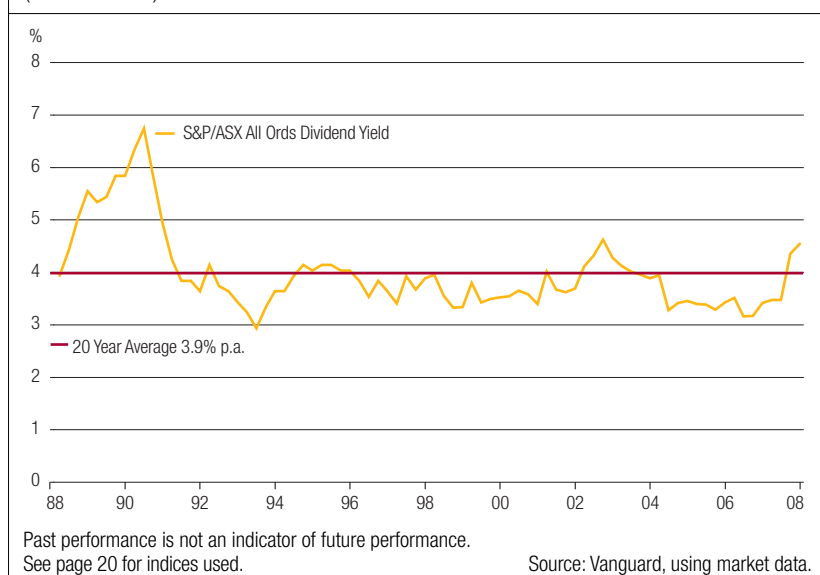
Beware of irrational exuberance

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 June 2008)



Australian shares dividend yield for 20 years (to June 2008)



## 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.

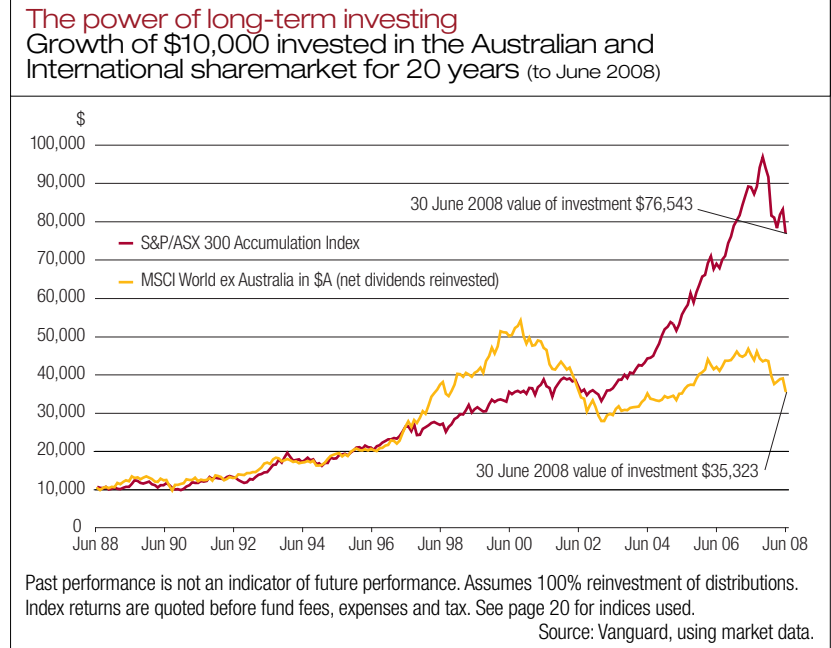
It is important to keep in mind there is no guarantee that share prices will recover to their previous value. Sometimes, there is a good reason why individual share prices fall, reflecting underlying poor corporate health.

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.



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

John C. Bogle, Founder, The Vanguard Group Inc., on market timing

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 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.

Despite these setbacks the Australian market has tended to even out over time. What has remained is a steady, upward trend reflecting the long-term growth of company profits in an expanding Australian and world economy. This has been great news for investors who have stuck to their investment plan and stayed the course.

### Buy-and-hold usually beats market timing

In June 1997, Jane and Sarah each decided to invest \$10,000 into an Australian shares index fund. Jane took a long-term approach and was patient through periods of market volatility. Sarah panicked when the market began to fall and decided she would try and time the markets to improve her returns. After 10 years, Jane's investment, (which she kept invested in the index) had grown to \$29,340 compared to Sarah's \$26,302. That's a difference of \$3,038 (before fees and expenses).

Date	Jane	Event	Sarah	Market Timing Strategy
30 June 1997	\$10,000	Start Investing	\$10,000	
31 October 1997	\$9,160	US sharemarket correction	\$9,160	Invests \$9,160 in cash
31 December 1999	\$12,685	Stock market growth	\$10,195	Invests \$10,195 in shares
30 April 2000	\$12,623	US stock market decline	\$10,145	Invests \$10,145 in cash
30 September 2001	\$12,974	Global uncertainty	\$11,014	Invests \$11,014 in cash
31 October 2002	\$13,486	Continued uncertainty	\$11,575	Invests \$11,575 in cash
31 March 2003	\$13,042	Second Iraq war	\$11,806	Invests \$11,806 in cash
31 August 2003	\$14,702	Positive market indicators	\$12,041	Invests \$12,041 in shares
31 January 2008	\$31,125	Impact from credit crunch crisis	\$25,490	Invests \$25,490 in cash
30 June 2008	\$29,340		\$26,302	

Note: This example uses fictitious characters and assumes both investors invested in the same Australian shares fund. In volatile markets Sarah chose to invest in a cash fund and when markets were good she reinvested in Australian shares. Returns do not include fees, expenses or taxes. This is an illustration only and does not imply these returns are available on any particular investment made today.

Past performance is not an indicator of future performance. Index returns are quoted before fund fees, expenses and tax. See page 20 for indices used.  
Source: Vanguard, using market data.

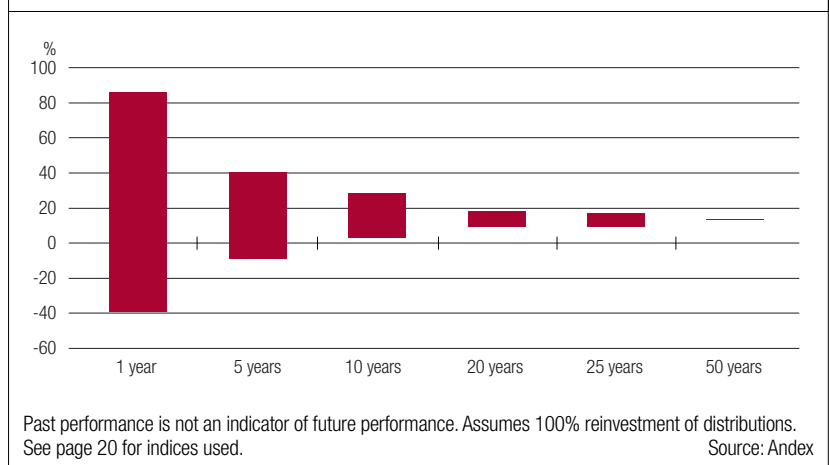
### Truth 2: Sharemarkets can be volatile

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 - 2008



### Truth 3: Bear markets are part of investing

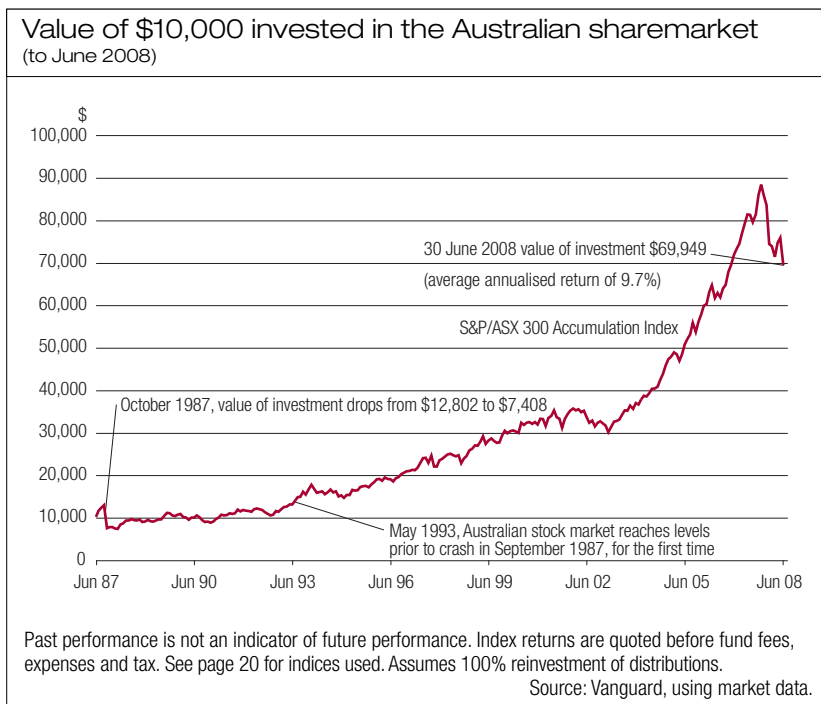
A bear market is generally defined as a decline in the sharemarket of more than 20 per cent over two consecutive months or longer. A bear market is not unique to shares and can also occur in bond and listed property markets.

Over the past 50 years, the Australian sharemarket has experienced a bear market, on average, once every five years. In October 1987, the

S&P/ASX All Ordinaries Index dropped by 42 per cent over a month, the largest monthly downturn in the last 50 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 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 that an investment of \$10,000 invested in June 1987 grew to \$12,802 before it dropped to \$7,408 in October 1987. It recovered to its original investment value of \$10,000 around two years later. Investors who stayed the course, rather than selling and cutting their losses, would have received around \$69,949 in June 2008 (before fees and expenses, assuming their distributions are reinvested).

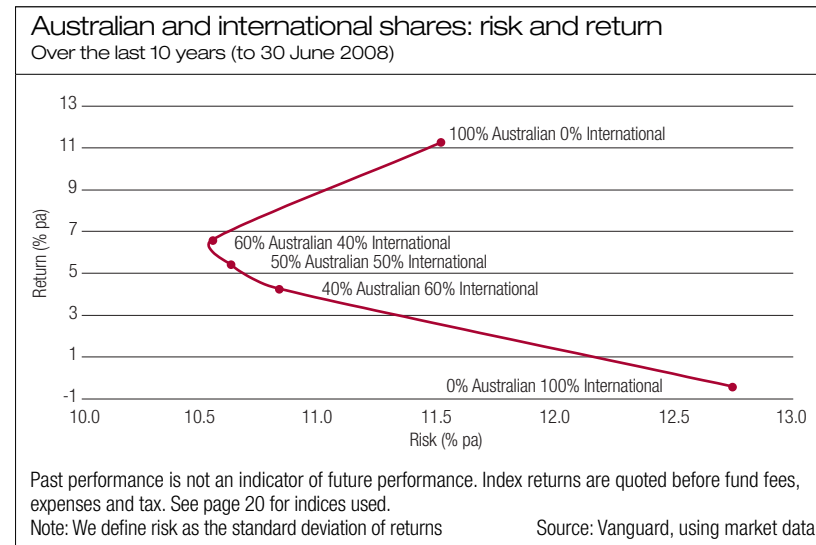


## Investing overseas

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

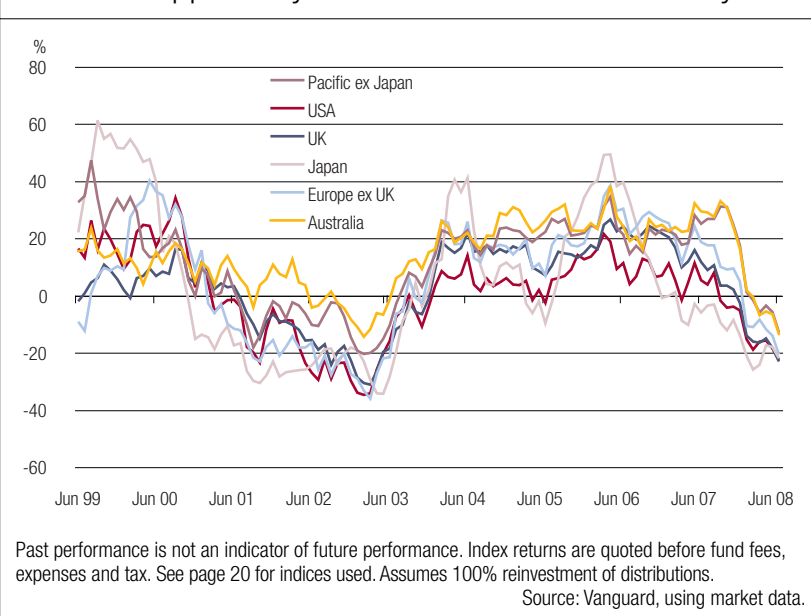
The Australian market is highly concentrated with a large representation in the financial services and resource sectors. The top 10 Australian companies make up more than 40 per cent of S&P/ASX 300 Index, with three out of the top five companies in the financials sector.

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.



The other benefit of investing internationally, is that investment markets tend to move in different cycles, driven by their economic health, and other factors.

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



The graph above shows the annual returns of major international and Australian equity markets over the past 10 years.

## 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.

“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 offers some words of wisdom in his *Little Book of Common Sense Investing*.

### 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 investment. Finding the right balance is a matter of weighing your investment objectives, risk/return profile and investment timeframe.

#### Tune out market 'noise'

It is human nature, at the first sign of trouble, to become nervous and want to save your investment value from falling. 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 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 the most 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 match 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 fund in the US in 1976. Vanguard has since become one of the world's most experienced and successful indexing specialists, managing more than AUD\$1.3 trillion worldwide (as at June 2008).

In Australia, we've been helping professional and personal investors invest through our unique style of indexing for more than ten years.

### Vanguard® index funds

Personal and professional investors alike can benefit from Vanguard's high quality, low-cost investment solutions.

Vanguard's indexing approach is a proven long-term strategy for wealth, super and Self Managed Super Fund (SMSF) investors. Our funds are available directly or on a wide range of platforms through financial advisers and include:

- Vanguard's *Investor Index Funds* are suitable for individuals, joint investors, SMSF investors, businesses and trusts; and
- Vanguard's *Personal Superannuation Plan* is a flexible super plan you can use throughout your working life.
- Vanguard's *Personal Pension Plan* offers a flexible account-based pension for retirees seeking a tax-effective income stream.

With Vanguard's low fees, around half the industry average of retail managed funds, you can be assured your investments are off to a head start. Scaled management fees apply to balances over \$50,000, so the more you invest the less you pay. And, there are no upfront fees.

Investors with more than \$500,000 to invest can access our range of index funds at wholesale rates.

### 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 30 June 2008. To view current performance data, visit our website [www.vanguard.com.au](http://www.vanguard.com.au)

#### Index 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 indices 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

- MSCI World 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

## Note

All currency is in Australian dollars unless otherwise stated. Unless otherwise stated data sources are Vanguard, using market data. Performance data is as at 30 June 2008. To view current performance data, visit our website [www.vanguard.com.au](http://www.vanguard.com.au)

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