

Making sense of recent market movements

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Recently, global sharemarkets have had a rough ride. In Australia, the All Ordinaries Price Index hit a record high on 20 July 2007. But by 17 August it had fallen by around 12 per cent. Since that time it has been recovering.

According to Mark Dutton, AXA's Chief Investment Officer, these recent market ups and downs can provide good lessons about investing and the importance of maintaining a well diversified and long-term plan.

A time for clear thinking

By their nature, sharemarkets will either rise or fall everyday. And it is important to realise that the recent turbulence is not particularly extraordinary.

In the period from January 1989 to July 2007 the Australian All Ordinaries Price Index has fallen by more than 10 per cent on 11 occasions. And over the same period the market has produced a total return of more than 750 per cent. Panic reactions to short-term volatility means investors can risk missing out on the long-term return potential of markets.

Individual market rises and falls are the result of both rational and emotional reasons. And, while investing will always be an emotional subject, it is important to remain focused on rational or fundamental market factors and maintain a long-term approach.

The US credit market

According to Mark, the recent market turbulence was triggered in the US by concerns about the security of some home loans and mortgages. However, the root causes of the problem had been building for some time. An extended period of positive growth had lulled many investors into becoming complacent about credit risk. Fierce competition among companies who lend money and the relative ease with which they could source funds meant that there was now a significant amount of lending invested in poorly secured loans at historically low rates.

As housing values started to fall in the US, the number of borrowers defaulting on loans increased. Losses on these loans impacted lenders and the means by which lenders obtain funds.

As a result, transactions in financial markets slowed dramatically. Buyers and sellers, lenders and borrowers, faced great difficulty carrying out their normal business. These conditions have since eased but will remain a source of volatility in markets for some time.

Central banks around the world have stepped in to supply the necessary liquidity to enable markets to function, and this has helped ease the immediate problems.

The sharemarket effect

Fortunately, sharemarkets entered this period in a generally strong position. Overall valuations on shares globally were a little below the long-term average, profit growth was strong, economic growth positive and interest rates and inflation relatively low. And, in contrast to the lending spree seen in the housing sector, company balance sheets were in very good shape, with historically low levels of debt.

During times of stress, markets often sell down very good quality company shares, as well as the poor ones and those exposed to the specific problem. When the stress has eased, good quality, well-valued shares can recover and continue to build solid long-term returns. The only losses not recoverable in the long run are those that were locked in by panic sellers, and those lost on poor quality assets.



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The advantage of a long-term diversified investment strategy

There is an old sharemarket saying that good investing is about 'time in the market, not timing the market'. The phrase highlights the value of a long-term approach and the potential error of jumping in and out of markets depending on the emotional mood of the day.

Mark says the main message in the wake of the recent market turbulence that investors should maintain a long-term and diversified investment approach.

"Short-term fluctuations will come and go for very specific reasons and they are likely to be big news at the time and highly emotional. But people shouldn't get caught up in the moment. Take a step back, assess the overall fundamentals. Ultimately, a long-term, well diversified rational approach will be rewarded."

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