InPerspective:

AUGUST 2011

Maintaining a long-term investment strategy

AT A GLANCE

- Stock market volatility and increased uncertainty arising from global events has negatively impacted investor confidence. This perceived increase in risk associated with growth investments can be disruptive to long-term wealth accumulation.
- Historical returns from stock markets show that investing in equities can deliver rewards over the long term, despite shorter term volatility and periods of market dislocation.
- Dynamics in human behaviour play a role in determining the approach to investment. These decisions and personal preferences can have a profound impact on wealth creation.
- Tried and tested strategies of compounding income, dollar cost averaging and diversification remain valid principles to follow in growing personal wealth.

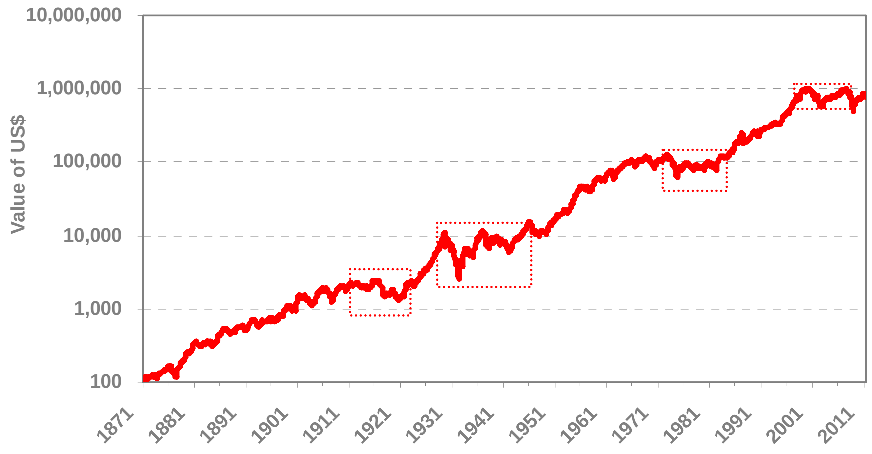
Recent years have not been easy for investors and some may have started to question their faith in equity markets. The view from experts has always been to invest for the long term, but the recent performance of some assets has led investors to question this wisdom. Despite the fall in confidence from stock market volatility, the ability of stocks and other assets to deliver attractive returns over the long term remains intact. This *In Perspective* discusses the influence of short-term market volatility on investor behaviour and the merit of sensible, long-term saving and investment.

THE LAST DECADE IN PERSPECTIVE

It is understandable in the current environment that investor confidence has been negatively impacted. An investor who bought into the world's leading companies a decade ago has suffered two of the worst market falls in more than 100 years. First, they watched their investments fall in the slump that followed the bursting of the dot.com bubble in 2000. They recovered almost all of their losses by 2007 only to see markets plunge again as the credit crunch triggered a global financial crisis. Throughout this period, natural disasters have hit major economies like the US, Japan and Australia, European nations gave birth to a sovereign debt crisis and geopolitical tensions have sent the oil price to record levels. But despite this difficult time, investors need to recognise the power of using stocks and other growth assets to deliver strong long-term returns.

To understand why stocks can deliver long-term growth, one must consider the past decade in a historical context. Market patterns show that poor periods are usually followed by good years. Stocks are an inherently volatile investment, particularly over short periods. Rises and falls can be frequent and unpredictable. But over the long term, stock prices have tended to rise steadily. The chart below uses US data to illustrate this. The trend over the past 138 years is clearly upward, but looking closely at the trend highlights long periods of time when stocks moved sideways from the top to the bottom of the trend channel. This is evident from the turn of the 20th century to the end of the First World War; through the Great Depression and Second World War; and during the inflation shock of the 1970s. However, in between these sideways periods are extended episodes of rising prices. This can be seen from the first phase of globalisation in the Victorian era, the explosion of US consumerism between the two World Wars, post-war reconstruction and a second phase of globalisation in the 1980s and 1990s. Although the past decade has been painful for investors, history shows this as just the latest sideways shift before the next long-term bull run begins.

REAL RETURNS FROM THE S&P 500 –A VERY LONG TERM PERSPECTIVE



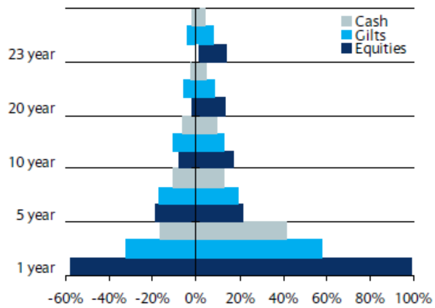
Source: Irrational Exhuberance', Robert Shiller, Prinston University Press 2008. Shows the real returns, adjusted for inflation and with income re-invested. Shown in logarithmic scale

The chart above shows when the US market recovered from some of the most severe bear markets in history. A key point to note is that, while it takes a long time for the market to recover fully, about half of the losses are recovered in a very short period after the lowest point is reached. This is represented by the "V" shapes evident in the shaded parts of the graphs. No one knows for sure when a market has reached the bottom of a trend. So an investor who waits until the outlook appears favourable risks missing the initial part of a recovery, the time when the most significant gains may be made.

PICKING THE NEXT BIG THING IN STOCK MARKETS

What might cause the next rise in stock prices? First, consider that the excitement surrounding the growth of the internet was not misguided but merely overblown and early. Ten years on, the froth has evaporated, but the internet continues to transform day-to-day life for both individuals and the companies they work for, in ways that were unimaginable not so long ago. Second, although growth in the emerging markets has been tempered somewhat by problems in their main export markets such as the US, development of the so-called BRIC economies of Brazil, Russia, India and China that have supported global economic growth over much of the past decade, has not come to an end. Finally, there is also a strong argument to suggest that a 'green revolution' will power economic growth in years to come as industry and the community adapt to more sustainable practices. Consider these together and the case for making an investment now is a lot stronger than the performance of the past decade might suggest.

POTENTIAL RANGE OF RETURNS OVER DIFFERENT TIME PERIODS



Source: Barclays Capital, "Equity Gilt Study, 2011"

WAITING FOR THE LONG TERM

The chart on the left is a snapshot of how long-term investing improves the probability of a positive return. It's taken from the 2011 edition of Barclays Capital's respected annual study of equity and bond returns, the Equity Gilt Study. It shows that since 1899 if a UK investor held equities for just one year, their inflation-adjusted return might have been as good as 100%, or as bad as -60%. But since 1899 there has not been one 23-year period where equities have lost money. Two important things can be understood about long-term investing from this chart. First, that the longer an investment is held, the narrower the likely dispersion of returns. Secondly, the chances of a positive return increase the longer an investment is held. Both points support the argument to maintain a long-term discipline when investing in growth assets.

INVESTING MEANS DIFFERENT THINGS TO DIFFERENT PEOPLE

Investment decisions need to be made within a broad and well-considered context. An individual's saving and investment goals, time horizons and appetite for risk are at the heart of these decisions. Making sense of the market and understanding what is happening now in the context of market history is central to helping make these decisions. The remainder of this discusses these considerations and useful strategies for wealth creation.

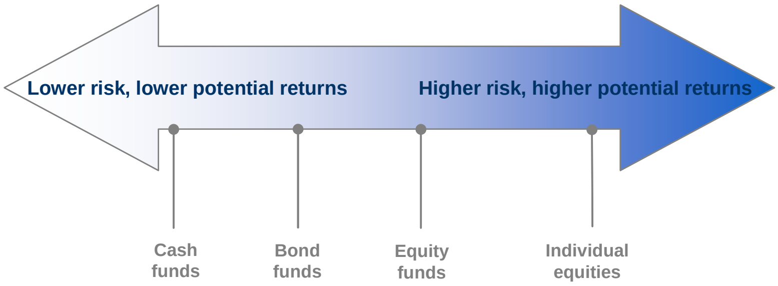
WHAT TYPE OF INVESTOR ARE YOU?

Most readers will understand the importance of making financial provisions for the future and have a savings goal in mind - perhaps for retirement, a holiday or just for future emergencies. You may also know how long you have to save - a year, ten years, perhaps longer. And you know your temperament - how well you could cope with the possibility of your investment falling in value. You should therefore be able to judge how much risk you are willing to take. Investment risk is like the volume dial on an amplifier – you can turn it up and down as you wish. In theory, the more risk you are able or willing to take, the greater your potential reward. Of course, more risk also means greater potential for loss.

GOOD RISK, BAD RISK

The notion of risk has been viewed negatively in recent years thanks to the excessive risks taken by some and the disproportionate rewards for taking that risk which came to light through the global financial crisis. This reaction misunderstands the nature of investment. There is good risk and bad risk. Good risk is calculated risk which is adequately rewarded and bad risk denotes reckless decisions which often lead to disaster. The extraordinary long-term outperformance of stocks over bonds and cash is a reflection of the reward investors have received for the calculated risk of investing in stocks.

THE RISK-RETURN SPECTRUM



A SPECTRUM OF ASSETS IS AVAILABLE TO INVESTORS

Investing offers a way to develop long term wealth. But investors need to choose from a range of investment alternatives by considering their risk and return prospects. **Cash** is the safest of investment classes. The problem with cash as a long-term savings asset is that this security comes at a price. Interest rates in the major economies are close to zero and the spending power of your money will wither away with even a relatively low rate of inflation.

Bonds are issued by governments and corporations to raise money. In return, the issuer will pay an investor a fixed rate of interest through the term of the bond and the initial amount in full upon maturity. Once issued, bonds are publicly traded so subsequent holders may buy and sell them for more or less than their face value. Government bonds are valued on the basis of official interest rates in the issuing country and the outlook for growth and inflation. However, bonds carry the risk of default which occurs if the issuer fails to make interest and capital payments.

Alternative investment assets - investors can buy assets like commercial property, commodities and other 'alternative' assets through managed funds. These also offer high growth potential and higher risk than cash or bonds.

Stocks offer potential rewards over the long term because investors stand to benefit from growth in the value of a company as well as through a share in corporate profits, issued as dividends. Stocks have also exhibited a degree of protection against inflation, but they are a volatile asset class, as can be seen over the past decade.

THE VALUE OF DIVIDENDS

When things are going well and the stock market is rising strongly, the extra return from dividends may be considered as little more than a token gesture. However, in weaker markets the extra return from dividends becomes a valuable part of the total return, especially over time as reinvested dividends are compounded. For example, US$1,000 invested in the Dow Jones Industrial Average in December 1987 would have grown to US$6,263 by now. But if the dividends had been reinvested it would now be worth US$11,371*, almost twice as much. Dividends can also be more reliable than both corporate earnings and stock prices during a bear market because many companies usually strive to maintain their dividend even if their profits are temporarily falling.

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1929: the great depression

Length of bear market: 31 months	Amount lost: 85%	Full recovery: 262 months

1973–74: oil crisis

Length of bear market: 11 months	Amount lost: 44%	Full recovery: 64 months

2000–03: dot.com crash and 9/11 attacks

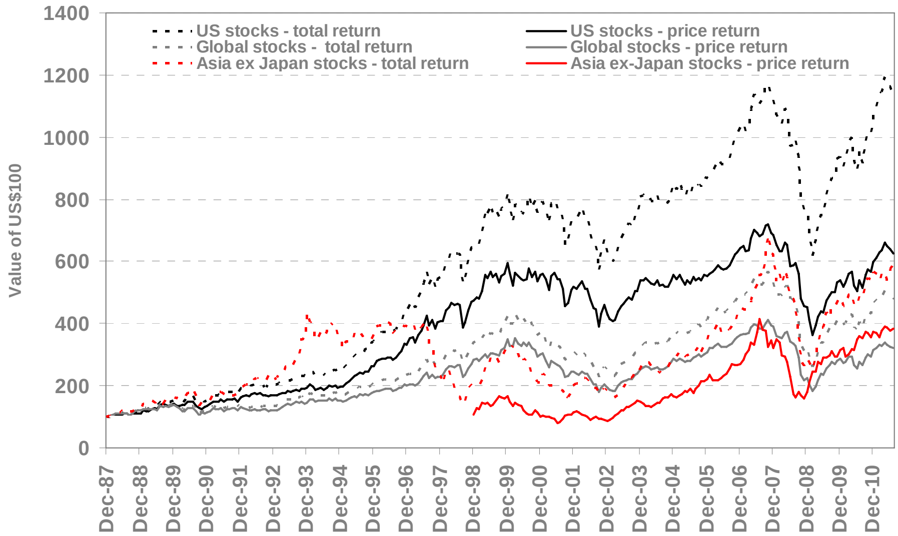
Length of bear market: 25 months	Amount lost: 49%	Full recovery: 56 months

2007–09: global financial crisis

Length of bear market: 18 months	Amount lost: 57%	Markets yet to recover from last peak

* Fidelity analysis, using Bloomberg data on Dow Jones Price Index and S&P 500 Price Index

THE TRUE VALUE OF DIVIDENDS



* Source: Fidelity analysis, using Bloomberg data on Dow Jones Industrial Average, MSCI World and MSCI AC Asia ex Japan Indices calculated in US dollars, to 31 July 2011

DIVERSIFICATION - A SENSIBLE INVESTMENT STRATEGY

Diversification has always been considered the first line of defence in reducing investment risk. Spreading your funds across different investments reduces the impact of an unexpected fall in one of them. In effect, it reduces the importance of each single investment decision. Fidelity's research shows the main asset classes perform differently at different times in the economic cycle. Fidelity's Asset Allocation Director, Trevor Greetham explains: "*Recently there have been no safe havens in the equity world. However, stocks and bonds often move in opposite directions. Commodities dance to their own tune, sometimes moving with stocks, sometimes against. Each time a bull-run in one asset class comes to a halt, leadership passes to another. When equities peaked in 2007, commodities surged. When the commodities ran out of steam in mid 2008, government bonds started their charge. When the world economy recovers from its current difficulties, stocks will take up the running once more. A well-diversified portfolio of stocks, bonds, commodities and cash would have performed well over the past 30 years with a low level of volatility.*"

WHEN IS THE BEST TIME TO INVEST?

Perfectly timing your investments to coincide with the top and bottom of market cycles is generally not possible. Long-term investors are better advised to remain calm through periods of volatility. Fidelity's President of Investments, Anthony Bolton warns: *"The worst mistake a private investor can make is to be sucked into markets when they are high and the prevailing mood is the most optimistic, only to then get shaken out at times when prices are falling and the outlook is uncertain."* The challenge for new investors is also a question of timing. Many investors experience a nervous wait for what they consider to be the "right moment". Unfortunately, that "right moment" is only clear once it has passed. The real danger of missing that crucial bottom is that the early part of the recovery is often the strongest. After the dot.com crash, it took 56 months for the US market to fully recover, but half of the total gains were made in the first 16 months*.

INVESTING EARLY IS THE KEY

Conventional wisdom suggests it is 'time in the market' rather than 'timing the market' that is the key to developing long-term wealth. Therefore, starting to invest early is important. The impact of compounding, which describes the exponential growth that can be achieved by earning interest on previously earned interest - is profound. The earlier you start investing, the longer your assets have to work in the market for you. Starting that strategy today or tomorrow is not too late but failing to act may result in falling short on assets when they're needed most.

DOLLAR-COST AVERAGING IS PRICELESS ADVICE

Investors who are nervous about timing their investment can make regular contributions to their asset growth in smaller tranches over a period of time. Regular savers, including those investing into managed funds with regular contributions are set to reap long-term rewards. This can be especially effective when markets are at a turning point. "Buying the U" describes the process of feeding money slowly into the market while it is still falling, through the bottom and up the other side as the market recovers. Monthly investments offer a way to benefit no matter how the markets are performing: If stock prices go up, the stocks you already own will increase in value. If stock prices go down, your next payment will buy more stocks. Such an approach eliminates the anxiety of timing large investments, can smooth the highs and lows of the market and even improve an investor's eventual outcome. As shown in the example below, the regular investor finishes the period with an investment that is worth more than if the entire amount was invested at the outset, even though the units are the same price at the end of the period as they were at the beginning.

HOW DOES DOLLAR-COST AVERAGING WORK?

	Amount invested (US$)	Managed fund unit price (US$)	Number of units purchased	Cumulative value of investment (US$)
March	1,000	1.25	800	1,000
April	1,000	1.10	909	1,880
May	1,000	1.00	1,000	2,709
June	1,000	1.20	833	4,251
July	1,000	1.25	800	5,428
TOTAL	**5,000**	**-**	**-**	**5,428**

A monthly investment plan can be a good way to maintain a long-term investment strategy and is a useful way of being disciplined about saving for the future. Before long, regular saving will be considered as a routine activity and an essential part of your budget. Investing is never a 'set and forget' activity - it requires regular monitoring. While deciding the right time to buy and sell different assets is best left to professional asset managers, instilling the discipline of regular investment into growth assets is destined to build wealth for when it is most needed.