Patience still the key to success

A guide to investment markets July 2012

The past five years have been an uncomfortable ride for many investors, who have endured ups and downs on investment markets as the fallout from the global financial crisis continues.

While it's difficult to ignore distractions at the best of times, it's particularly hard when markets are so volatile and the daily speculation from commentators and analysts reaches fever pitch.

In fact, the noise is so loud that it's drowning out the untold story about economic growth, company profits and dividend yields.

The untold story, part 1
Global economy is growing

Memories of the global financial crisis remain very vivid and investors are continuing to react with heightened sensitivity to the daily flow of political and economic news, such as European sovereign debt negotiations and US employment figures.

While these developments are important, they are not the only story. With all the doom and gloom around, it might come as a surprise to learn that the global economy is set to grow by more than 3 per cent this year, driven by emerging economies such as China. The US economy is hitting its expected growth targets, and even in Europe forecasts predict only a mild recession.

The untold story, part 2
Companies are delivering decent profits

Just as important is the fact that many companies are in good shape with reduced costs, low debt levels, positive cash flow and increased profit margins. Once investors start focusing more closely on individual companies and industries, and less on dramatic headlines, share prices should benefit.

The untold story, part 3
Investors are harnessing the power of dividends

In our nightly news bulletins we hear a lot about share prices going up and down, with the headlines tending to be particularly breathless if prices have fallen. But we don't tend to hear so much about dividends – the regular payments made to shareholders by listed companies that mean you're receiving an income regardless of the underlying value of your investment.

And there's even better news if you invest in Australian companies that release franked dividends, when the company is already deemed to have paid tax. Once you include franking credits, the dividend yield of the Australian sharemarket is around 7 per cent. Essentially, this means Australian investors are receiving a reward in the form of a regular income as they wait for a recovery in prices.

Making the case for growth assets

Cash and term deposits are smart options for the part of your investment portfolio where you need to meet short-term expenses and maintain liquidity.

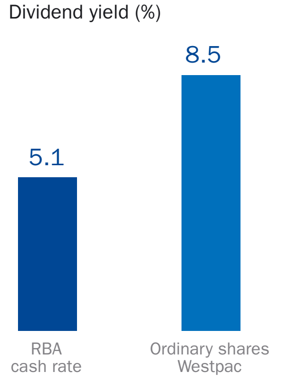
At the height of the global financial crisis, many investors started to find the perceived safety of term deposits an attractive option thanks to unusually high rates and ongoing market volatility.

And for good reason – term deposits are widely available, offer competitive returns and are easy to use. But as interest rates ease, investors keen to benefit from market upturns and dividend payments are starting to revisit growth assets for long-term investments.

Let's look at Westpac shares. Its dividend yield in May was 8.5 per cent. Compare that with a 12-month term deposit rate of 5.1 per cent and we see that owning Westpac shares offers an extra 3.4 per cent in annual income. And of course, shares offer the potential for capital growth over the medium term.

Source: Morningstar and AMP Capital

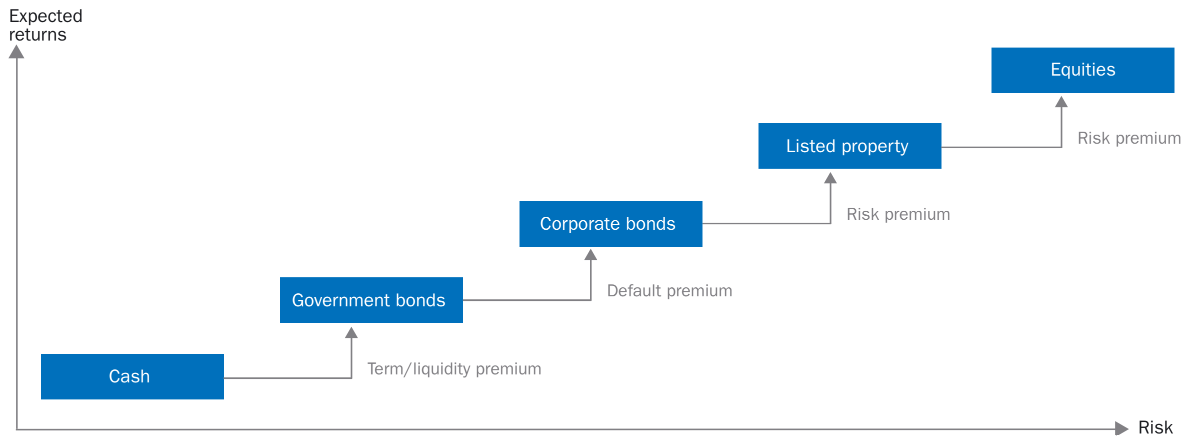
Shares are trading at attractive dividend yields



Climbing the risk and return ladder

The higher you climb on the risk/return ladder, the higher the potential returns but the greater the risk you need to take. Cash deposits are generally very safe but returns are usually low. Shares involve more risk but the potential returns are higher. For most long-term investors it's not a case of choosing one or the other. To spread risk without sacrificing return, it's usually smarter to have a combination of investments.

Expected long-term returns and risk



Returns provided above are not forecasts and are intended purely to illustrate premiums.

Source: ipac 'timeless investing: 2011 edition'.

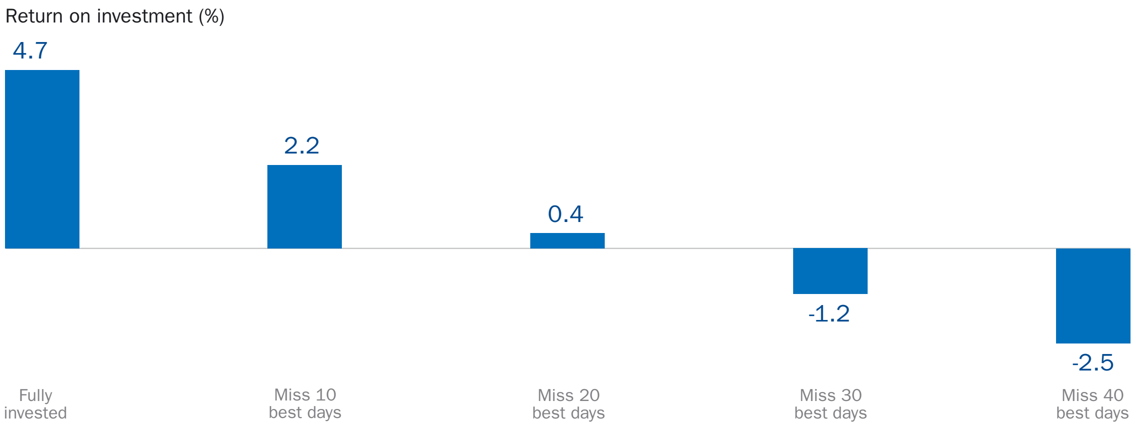
Missing the best days can destroy returns

Many investors understandably feel under pressure to react instantly to day-to-day market fluctuations, particularly in turbulent times. It's tempting to move your funds to safer ground when stock values start to decline. But trying to time when to exit the market is a high-risk strategy and means you could easily miss out on potential gains when reinvesting.

History bears this out. Stay fully invested in the Australian sharemarket for the 20 years to December 2011 and, before fees and taxes, you'd have achieved an average annual return of 4.7 per cent. Miss the 10 best days during this period, and the return falls to 2.2 per cent. Miss more of the best days, and it falls further. The only way to be sure of capturing the best days is to stay in the market. Market timing increases risk – get it wrong and it destroys returns.

Time invested in the Australian sharemarket

2 January 1992 to 31 December 2011



Source: Bloomberg. ASX All Ordinaries Index. Data from 2 January 1992 to 31 December 2011

Medium-term forecast: clouds lifting

Rolling news stories such as Europe's sovereign debt troubles have dented the confidence of many investors. However, if we step back from the daily market chatter, we can see that many companies are delivering strong balance sheets and healthy profits. And there's confidence that companies delivering quality goods and services will continue to do well in the medium term.

This is a frustrating period for investors. Nevertheless, some economic indicators that have been acting as a brake on Australian share prices have started to ease. While the path forward is marked with challenges, recent falls in the value of the Australian dollar and the official cash rate should act as a boost to investment markets.

Same investing rules still apply

In uncertain times it's more important than ever to hold fast to the fundamental principles of investing – diversify across a variety of asset classes, invest for the long term, take advantage of tax-effective superannuation and seek quality financial advice.

These principles have periodically come under scrutiny throughout history but they have emerged from every market cycle to stand the test of time.

Important information

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