Point of view

Mark Dutton, Chief Investment Officer – AXA Australia

Navigating 2012

The Chinese 'Year of the Dragon' is said to symbolise uncertainty, transition and change. This is a fitting analogy for where we find ourselves at the beginning of 2012. In this Point of View, Mark Dutton sets out some key strategies to help navigate this kind of environment successfully.

Where am I going and how do I get there?

Many drivers now have GPS units to help them navigate to a destination. All you need to do is input the address, and follow the instructions. But even the best GPS unit can't allow for unforseen situations such as heavy traffic conditions, closed roads or a host of other variables that may affect the journey. Nor can they allow for extreme events such as floods or bushfires that may change and make the intended route very dangerous.

Even in boom times, investing is never as simple as following GPS directions. There are always uncertainties, and 2012 may appear to have more than its fair share.

A challenge for successful investing is to avoid making poor decisions in the face of this uncertainty. The good news is that it is possible to put in place strategies to bring this risk down to acceptable levels, and still keep access to sound opportunities to grow wealth.

Changing nature of risk

Future investment returns are rarely certain.

Analysts generally think about a range of possible returns, expecting that the most likely outcomes will be near the middle of that range, with a smaller chance that some will be much more or less.

This is commonly modelled as a statistical 'Normal' distribution of probabilities and outcomes, as shown by figure 1, which has been a reasonably good estimate of what to expect most of the time.

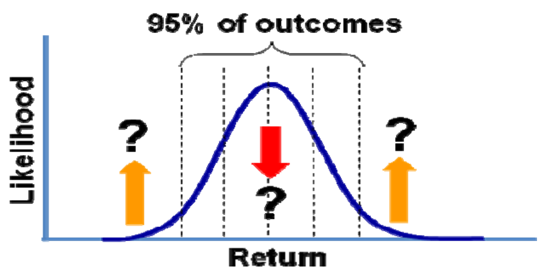
In this model, 95 per cent of outcomes are expected to be within a range of two 'standard deviations' higher and lower than the most likely estimate.

For example, sharemarkets might be expected to return between -12 and +24 per cent in a year 95 per cent of the time.

Since the on-set of the GFC, the ranges of possible outcomes have become wider than 'normal'. The likelihood of specific events, whether they appear as good or bad, has increased the changes of returns outside the 'normal' range.

This is what the world's biggest bond fund manager, PIMCO, mean when they describe the current outlook as 'unusually uncertain'.

Figure 1: The 'Normal' distribution of risk



Source: AXA

Understanding the forecasts

With economic and market forecasts flying thick and fast, there are several potential traps for investors.

The first is being blinded by the headlines. The International Monetary Fund (IMF) recently reduced the global outlook for growth to 3.3 per cent, which is below the long-term average of 4 per cent.

These revisions are not new news, which is one reason markets didn't react much. In fact the good news is that this growth is still well above 'recession' levels. For Australia, the prospects still look relatively positive, with developing Asia projected to grow most rapidly at 7 ½ per cent.

A second trap is not remembering figure 1. In a speech given late last year, the Governor of the Reserve Bank, Glenn Stephens, highlighted the importance of looking at a range of possible outcomes, not just the middle estimate.

However, there can be a sting in the tail of these ranges. The IMF forecasts include some dramatic possibilities, including the potential for similar type of trends to the 1930s.

These warnings are not predictions, but rather stern words to policy makers highlighting the need for clear action on European debt problems.

Just as drivers should not ignore a weather warning, which includes the chance of a gale, investors should not ignore warnings about changes in risks.

Have a plan

Authorities around Australia are urging households to have plans for risks such as bushfires and floods.

Investors also benefit from having a plan, especially in periods of increased uncertainty. It's important that the plan includes actions that can be taken to bring overall risk back towards the intended level.

Three key actions to help resilience include:

1) Increase diversification. Some investors question whether diversification worked during the GFC, when actually it did.

The 'flight to safety' response to stressed markets meant that government bonds rose in value as sharemarkets fell.

Almost all other risk based assets were adversely affected during the 'financial' crisis, as portfolios were not truly diversified against that type of risk.

Better diversification now means a greater spread of asset classes, diversification by geographies and different economic risks, and different strategies within asset classes.

2) Align assets with specific needs. For some investors drawing income from a standard 'balanced' portfolio may not be the best approach when markets are moving quickly.

A dedicated set of assets for liquidity needs, and regular income requirements can increase the likelihood of meeting those needs, and also reduce the risk of being forced to sell longer term growth assets when the markets are depressed.

3) Adjust 'strategically'. When markets move through large ranges over short periods, the basis for the initial investment structure may have changed, and new attractive opportunities may have emerged.

Adjusting a portfolio in response to these changes has nothing to do with speculative trading. It is about remaining true to the intended strategy, and adjusting for changes in the opportunity set. Some new innovations in managed funds are building more flexible asset allocation processes to address this need. Others offer forms of insurance against unwanted outcomes.

What this means for investors

While the media loves them, the least useful forecasts for investors are the predictions of future market levels.

Forecasts about the level of the sharemarkets, currency or the price of gold by the year end make great headlines, but have no real value for investors.

They are merely predictions about the unknowable and not something to base a strategy around.

An investment strategy that allows for a range of outcomes and includes a plan to manage risks is likely to yield a better outcome.

Sometimes we may need to override the GPS.

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