

# It's scary out there

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## Philip Baker

Had a gutful of the wild ride in shares during the past few years? Don't worry, you're not alone. Put off by the global credit crisis, retail investors have their lowest exposure to the local sharemarket since 1995, while their holdings of cash are at a 15-year high. And they're not the only investors heading for the door.

Key offshore fund managers are heading back home after spending \$84 billion on Australian shares from the middle of 2008 to the end of 2009.

Analysis by Deutsche Bank shows there was a net outflow of foreign investment in the first six months of this year as major players pulled out of the local sharemarket. Since then the local market, as measured by the S&P/ASX 200 Index, has underperformed the global market. So far this year the index is down 9 per cent, while the Dow Jones Industrial Average is down 1 per cent, the FTSE is down 3 per cent and the Nikkei is down 12 per cent.

Offshore investors aren't expected back any time soon, but what about local investors – why aren't they picking over the scraps the foreigners left behind? What's making them so scared?

Is it because they are bruised and battered after losing money during the past few years – the index is still 53 per cent from its record high reached on November 1, 2007.

And to make things worse, the so-called “mum and dad” stocks, many blue-chip leaders, are underperforming the index.

No wonder then that thousands of retail investors are seeking comfort in the high interest rates on offer for cash.

And it's not just happening here. The American Association of Individual Investors reports that bearish sentiment is at its highest level since 1987, when its record-keeping began.

Even local fund managers are avoiding stocks and are holding a near record amount of cash, about \$216 billion, according to Citi estimates. The broker reckons that for fund managers to get back to their normal cash levels, they would have to spend about \$50 billion on shares.

Arun Abey, co-founder of financial advisory firm ipac, says there is an extraordinary amount of fear around and that is what is underpinning rising cash levels, both in Australia and the US.

“This is the first time that I have observed in the US cautious pessimism, rather than cautious optimism during this stage of an economic recovery,” Abey says.

“Politicians are fuelling this fear, as evident in the Australian election campaign at the moment.”

Other factors driving the fear include the belief that sovereign debt reduction programs under way around the globe will take longer than expected, and there could be a number of malfunctions along the way.

“The sheer complexity of the modern world economy makes what is going on difficult to understand,” Abey says.

Compounding the problem, he says, is the complete loss of trust in financial institutions, regulators and the US government.

Melbourne-based adviser Paul Moran, from Paul Moran Financial Planning, believes many investors who were in the sharemarket over the past few years should not have been there in the first place.

“Investors who were saving for something, sometimes a house, sometimes something else, ended up putting their deposit into the sharemarket without realising the risks,” Moran says.

“It meant that there were more investors in shares than there should have been. Those sorts of investors now know the risks and won't be back soon.”

Companies are in the annual reporting season and strong profit results in the US and Europe have provided shares with some positive news.

But concerns that the global economy could slip back into recession, the so-called double dip, are likely to persist and many analysts think there is more selling to come as investors head into the seasonally weak months of September and October.

“There is a wall of worry out there right now, with risks that you wouldn't have expected a year or so ago, says the global

chief investment officer of Russell Investments, Peter Gunning. "The stand-out one is the worry that a sovereign-rated country might default. Then there is the whole global economy, China and Europe.

"But I'm not sure it's time to be scared. If anything, there is opportunity."

Investment Trends, a specialised market research company for the wealth management industry, reports investors are almost as worried now as when the credit crisis was in full swing. Principal Mark Johnston says that at the height of the global financial crisis, when asked how worried they were, 7.4 out of 10 investors replied they were "very concerned". That dropped to 6.3 out of 10 during the middle of 2009 as the sharemarket recovered, but it's back up to a reading of 7 out of 10.

"People are worried about a second wave," Johnston says.

To get back into shares, many will need hard evidence that the economy has recovered, more confidence in the sharemarket numbers, better offshore markets, credit markets back at more normal levels, and more positive media reports.

"What we are also seeing is that investors are narrowing their investments to blue chips and cash. That means no more hedge fund, no more small caps or managed funds," Johnston says.

They have lowered expectations and perhaps aren't so worried about missing out on the spectacular gains that investors enjoyed between 2003 and 2007.

"They see returns from shares at around 9 per cent, whereas they used to expect 11 per cent."

The poor level of activity in the initial public offering market reflects the uncertainty in sharemarkets. According to Deloitte, in the six months to December 2009, IPO activity was upbeat but then stalled in the next six months. A successful listing of Bilfinger Berger's local business was supposed to be the deal to fuel the local IPO market. But the 11th-hour decision by the German parent to pull the \$1.3 billion offering has dashed those hopes. Vendors who had delayed \$9 billion of IPOs until later in the year again retreated to the sidelines.

But not everyone is pessimistic. There is reason to buy stocks: valuations are certainly cheap. The market's forward price-earnings multiple (P/E) of about 11.5 times earnings doesn't look onerous relative to its long-term average of close to 15 times.

Offshore markets appear to look attractive and could give the local market a positive lead.

Bill Miller, the Legg Mason fund manager who beat the US S&P 500 index for a record 15 consecutive years, says investors have a "once in a lifetime" opportunity to buy large-cap US stocks at the lowest prices in almost six decades.

One of his key philosophies is to average down relentlessly. "Two things seem pretty clear to me. First, no one can consistently buy at the low or sell at the high, except liars; and second, lowest average cost wins," Miller says.

"We consistently strive to lower the average cost of our positions by buying more if and when the price drops."

But few people appear willing to buy into stocks right now.

The retail investors who flocked to the sharemarket in the 1990s have had to put up with more than their fair share of woes ranging from the Asian financial crisis, the Long Term Capital bailout, the tech wreck, the fallout from September 11, 2001, to the accounting scandals of Enron and WorldCom and the global financial crisis.

The privatisation and demutualisation boom of the 1990s brought hordes of small retail investors into the sharemarket. But the results have been mixed.

Stockbroker CommSec has constructed what it calls the Mums and Dads Index. The index contains 10 equally weighted stocks that are household names or have been the subject of demutualisation or privatisation.

Those stocks are AMP, Commonwealth Bank of Australia, Myer, IAG, Qantas, Suncorp, TAB, Tabcorp, Telstra and Woolworths.

Over the past 12 months, the index is up 2.7 per cent compared with a 7.4 per cent gain in the All Ordinaries Index.

The performance of the index doesn't include BHP Billiton.

Over the past two years, the index has fallen 3.3 per cent compared with a 7.5 per cent fall in the All Ords, while over the past five years, it is up 2 per cent compared with a 6 per cent rise in the All Ords.

However, over a 10-year period it is up almost 46 per cent compared with a 42 per cent gain in the All Ords.

CommSec retail distribution general manager Brian Phelps says retail investors aren't exactly scared, but they have educated themselves better in the aftermath of the global financial crisis.

"During 2009, with the global financial crisis, a lot of people went to cash and we were net sellers of shares," Phelps says.

"But from midway 2009 to the beginning of the 2010 financial year our clients were back buying."

The 2010 financial year was the broker's strongest trading year.

After averaging 50,000 trades a day in 2008 and 2009, the broker handled 76,000 trades in 2010, which included seven of their largest 10 days on record.

However, margin loans with the broker fell from \$10 billion to \$6 billion in 2009 with a 23 per cent increase posted in the past year, while cash holdings peaked at \$2.6 billion last year.

"We have taken a view of education that has led to a number of things," Phelps says.

"The average number of shares in a margin loan went from four to eight, so investors are diversifying their portfolios and they have left more in cash."

Making some analysts nervous about shares is the fact that some market valuations are getting a free kick from ultra-low bond yields.

Sharemarket analysts typically use the 10-year bond yield when calculating today's values of a firm's future cash flows.

A lower bond yield delivers higher value and vice versa, while the 10-year bond yield is currently hovering close to its lowest level this year.

In addition, the "E" part of the forward P/E is based on upbeat expectations.

Downgrades to prospective earnings would quickly push valuations above long-term averages and would be likely to result in downward pressure on share prices.

Consensus earnings growth for 2011 was as high as 25 per cent a few weeks ago, but already that is starting to be revised down and some analysts are tipping them to fall further after the reporting season.

Perhaps what is harder to quantify is a new feeling of conservatism among investors.

The latest retail sales data shows that consumers are feeling decidedly more uncertain.

Sure, they will spend but it takes cheaper prices to get them to part with their cash.

While most consumers have held onto their jobs during the crisis, they are more cautious and conservative and perhaps this is spilling over into their investments.

In the late 1980s, there was "irrational exuberance", now there is "new conservatism".

Family Office Research and Management's Tom Murphy, who helps look after clients who have at least \$3 million to invest, isn't quite so sure about that theory, but he has been advising clients to be underweight equities since the middle of 2007.

He reckons there's a simple reason investors have so much money in cash now: it pays well.

"The banks are overpaying for term deposits right now and it keeps investors in cash. You can get 6.25 per cent and once you take inflation into account, that's a safe way to go," Murphy says.

He hasn't given up on stocks altogether, but says large caps and emerging markets are the only things he's looking at.

"We are still very worried about a drain of capital and fear that small-cap stocks will wear the brunt of the massive maturities that the banks have in 2012," Murphy says. "The small to medium companies might struggle to get any money when all those loans need to be rolled over. It's another reason why the banks are paying up for deposits."

If he were to start recommending stocks again, Murphy says he would need to see stronger bank balance sheets around the globe and a wave of mergers. He expects the major index to trade between 4200 to 5500 in the foreseeable future. The index closed on Friday at about 4450.

Reinforcing his view is the recent run of economic data, which confirmed that the global recovery is losing momentum.

It seems the wave of austerity engulfing Europe right now is spilling over into the rest of the world, with too many people wanting to save and not enough people wanting to spend.

In the US, housing starts, building permits, existing home sales, durable goods orders, construction spending, pending home sales, auto sales and retail sales have all softened over the past month.

Second-quarter national accounts showed the world's largest economy was now growing at 2.7 per cent, down from 3.5 per cent in the first quarter.

Contrast that growth rate with the first half of 2010, when the global economy was growing at above-trend pace and commentators were pointing to the need for a slowdown to prevent a boom-bust cycle from taking over.

In fact, a slowdown is not unexpected. Witness similar events back in 1994 and 2004 before resuming growth a year later.

After last calendar year's positive gains in shares, up 34 per cent, this year is certainly proving to be a lot tougher.

But again that's not unusual. In 1992 and 2004, shares also went through a soft patch after a sharp rally following the bear market lows in 1991 and 2003. The rally resumed in 1993 and 2005.

Over the past 12 months, the Australian sharemarket has been trading water and is now around levels seen in late 2005.

Current valuations are 15 per cent below their 15-year average and industrials are around 10 per cent below their 15-year average.

Royal Bank of Scotland estimates that pension funds are holding as much as \$55 billion in cash, deposits and short-term bank debt, which implies that if global markets seized up again, there would be less forced selling by banks.

Tyndall Investment Management's head of equities, Bob van Munster, says current market conditions are triggering a number of classic investment behaviours that can lead to bad decisions by investors.

He says that "confirmation bias" is a classic investor behaviour during times of uncertainty and volatility, but one that can be dangerous, particularly when the company reporting season is under way.

"Confirmation bias sees investors gravitating to those people and sources who they know share and agree with their views when seeking information," Van Munster says.

"For instance, they may only read the views of a commentator who shares their opinion on how markets will perform, or prefer to talk about the sharemarket with friends who have the same investment philosophy or risk profile.

"Investors may also ignore any opinions that disagree with their own, discounting any research or statistics that show a different conclusion to the one they already hold.

"Unfortunately, such behaviour often becomes more common during periods of market uncertainty and volatility, when investors can be bombarded with different and contradictory information, and therefore cling to one point of view rather than trying to rationally assess all the data available," Van Munster says.

The Australian Financial Review

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