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After the GFC, investors worldwide are questioning whether time-honoured investment strategies still work. In this article, Vanguard's Robin Bowerman puts five key strategies to the test, including dollar-cost averaging, diversification, and portfolio rebalancing, and argues these simple ideas are more powerful than ever in volatile markets.


By Robin Bowerman, Vanguard Australia

Global financial crises and periods of extended market volatility have a way of challenging accepted wisdom. So it is hardly surprising that investors here and around the world are questioning whether the rules of the game have changed, perhaps forever.

Are time-honoured strategies such as diversification and portfolio rebalancing past their use-by date? Are there new strategies that investors need to be considering in a post-GFC world?

Visiting Australia in October was world-renowned economist, academic and author Dr Burton Malkiel, Professor of Economics at Princeton University in the US. He is perhaps best known for his seminal investment classic, *A Random Walk down Wall Street*, which is in its 10th edition and has sold more than 1.5 million copies.

Dr Malkiel says that as he travels around the world to investment conferences, he hears that strategies such as diversification are dead. He argues strongly that, far from being dead, this is a time when a back-to-basics approach to investing will serve investors well.

Here we look at five back-to-basics strategies and how they have fared in volatile times.

1. Dollar cost average - get the best and worst

This discipline of investing regular amounts at regular intervals over a period of time results in investors capturing the best, and worst, of market movements and everything in between.

What has perhaps been clouded by market moves over the years is that dollar cost averaging actually works better in volatile markets than when they are steadily climbing. This is because you are regularly buying into the sharemarket and inevitably buying shares/investments at prices that are at times low and at other times high. The overall effect is that you average out the price of the shares you buy and reduce your timing risk.

Dr Malkiel uses an example where \$1000 is invested over five time periods. The market price of the index fund used in Malkiel's example begins at \$100, falls to \$75, and falls further to \$55, before bouncing back to \$110 then settling back at \$100. In other words, after five investment periods the market ended up precisely where it started. The investor using dollar cost averaging ends up with a portfolio worth \$6060.

By contrast, if you had invested the same amount in a market that rose steadily from \$100 in \$10 increments to \$140 - arguably an investor's dream market - you would have ended the period with a portfolio worth slightly less at \$5915.

The alchemy of the arithmetic lies in the average cost of the shares or units purchased.

The message here is less about the end portfolio value and more about overcoming behavioural biases. Investors feel good about investing when markets are trending up steadily, or even rapidly. Markets that move like a roller-coaster unsettle us and create doubt about the wisdom of investing - or at least cause us to wait for a sign that times have improved.

2. Rebalance - lower your risk

The idea of rebalancing certainly has simple appeal. You set the target asset allocation that suits your personal risk profile and, at regular intervals - typically once a year - you rebalance back to those target weightings to ensure the portfolio risk is staying within the guidelines you set.

But, in a practical sense, this can be one of the hardest emotional challenges an investor can face - the notion of selling winners and buying losers.

Consider the example Dr Malkiel uses. He modelled a US portfolio from January 1996 to December 2010. The portfolio invested 60 per cent in the US Russell 3000 index and 40 per cent in the Barclays US Aggregate bond index: a simple portfolio combining exposure to the broad US share and bond markets.

It was rebalanced in January each year and it covered both the technology bubble in 2000 and the global financial crisis in 2008. The rebalanced portfolio delivered an average annual return of 12.19% with a risk (or volatility of returns) of 11.5%. By contrast if the investor did not rebalance the portfolio, the average annual return was 10.72% with a volatility of 12.75%.

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Dr Malkiel makes the point that rebalancing does not always give a higher return, but it always gives a lower risk or volatility level. He also points out that in this portfolio; in January 2000 the investor did not know the sharemarket was nearing the peak of the tech-stock bubble. But the run up in prices had pumped up the shares to be well outside the asset allocation guidelines, so the rebalancing signal was to sell down shares and buy more bonds to keep the risk level under control.

Conversely, in 2003 the investor did not know that shares were nearing the bottom of the market cycle, but bond prices had risen significantly, so the rebalancing saw bonds being sold and shares bought to restore the asset allocation balance.

To test rebalancing in an Australian context, Vanguard modelled a similar portfolio - 50 per cent in Australian shares (S&P/ASX 300 index) and 50 per cent in Australian bonds (UBS composite bond index) over the past 10 years to the end of September 2011. If the portfolio was rebalanced each year, the annual return was 6.99 per cent. For a portfolio that was not rebalanced, the return was 6.73 per cent.

The performance result was not as strong as Dr Malkiel's example. However, the total risk taken was significantly lowered, which is perhaps the most powerful argument for using this strategy.

In volatile times, rebalancing helps investors take a disciplined approach to keep portfolio risk within levels that they are comfortable with and in control of.

3. Diversify - across and within

Continuing on the theme of keeping risk under control is the strategy to ensure a portfolio is well-diversified.

Dr Malkiel is a strong advocate of broad market diversification and while he acknowledges there are few places to hide during a worldwide recession, it does not mean the death of diversification.

Diversification comes in two key forms: across asset classes and within asset classes.

There is a strong body of investment research that points to asset allocation being the single most important decision an investor makes. For Australian share investors, the diversification question is multi-faceted and involves comfort levels with Australian shares, international shares, property, fixed interest and cash.

Our market is heavily concentrated in the financial services and resources sector, so even within our broader market there is considerable sector risk. A level of home country bias is understandable, therefore being overweight in Australian assets is sensible, but not to the total exclusion of overseas markets.

Correlations between asset classes (that is, assets moving in the same direction) may have risen in recent years but Dr Malkiel argues the return differential still delivers benefits. He uses the example of developed-world sharemarkets versus emerging markets. Emerging markets do correlate (or follow) developed markets closely. But in the past 10 years, while developed markets (in particular the US) ended up around the same level, emerging markets delivered an annual growth rate around 8.3 per cent.

A clear example of Australian investors using diversification effectively is the increasing cash holdings in self-managed super funds (SMSFs). Attractive short-term interest rates have seen SMSFs build up cash holdings, usually in term deposits, to around \$113 billion, according to Investment Trends research in May this year.

This is where diversification and rebalancing work effectively together. At the designated rebalance time, if the cash/term deposit holding is above the target asset allocation an investor has decided suits their long-term goals and risk appetite, it is a call for a strategic rebalance.

4. Core-satellite - build stronger portfolios

Dr Malkiel's *A Random Walk Down Wall Street* mounts a strong argument against trying to time markets. It is, he argues, a zero-sum game and that is before costs are taken into account. But for those who want to tilt their portfolio (towards an asset class, market or stock) or who have a high level of confidence in a particular share or style of investing, he suggests a core-satellite approach.

This means locking in the market's return via broad market investments such as exchange-traded funds (ETFs) or index funds in the "core", and then investing in "satellites", be they specific shares or other active management investment products.

This allows investors to take "bets" to try to improve returns and also add assets that further diversify risk.

5. Costs matter

It may not be an investment strategy in its own right but one of the other timeless lessons that Dr Malkiel reminded us of during his visit to Australia was that costs matter - a lot. He does not believe you can forecast market returns reliably, but you can calculate your costs with certainty.

About the author

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