The *Realities of Investing*

Investors make unrealistic assumptions when they think that the investment they hold will continuously appreciate in value every year. They tend to look at the long-term performance numbers of a selected portfolio and think that its short-term performance is like-wise made up of a sequence of positive performance numbers.

The reality is that the investment world, much like our physical world is full of uncertainties. And, at any point in time, market events could make completely rational investment approaches seem irrational.

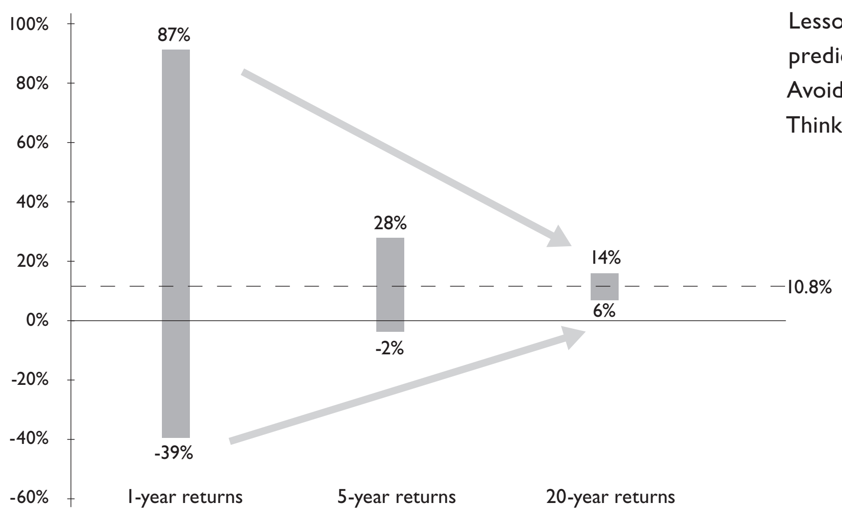
There are two personalities at the heart of each investor – the short-term investor and the long-term investor. And, from time to time, we get led by each of these investor personalities. The rational approach to investing should always be to listen to the voice of the long-term investor, rather than the more exciting voice of the patience-deprived short-term investor.

The realities are that the short-term investor reacts to the flow of short-term news, while the long-term investor holds their course and makes rational investment decisions based on long-term business fundamentals. Relative to the short-term investor however, it is the long-term investor who stands a better chance of earning stable returns on their investments.

When one adopts a rational long-term approach to investing, the upside and downside volatility on their investment returns may narrow over time.

A wise investor understands that having negative returns at some point during their investment cycle is a realistic expectation. However, the extent of negative returns, its frequency and an investor's ability to tolerate these needs better understanding.

Stock Market Returns 1956 – 2010



Lesson: Returns only become predictable over long-term. Avoid short-term thinking. Think long-term.

Source: S&P TSX, Morningstar Direct

Highest/lowest rolling returns for the S&P/TSX over various time periods.

Average annual returns.

Of course there will always be signs of worry in the financial markets. Be it the credit crunch, income trust legislation change, technology appreciation, troubles in the Middle East, or terrorist attacks in city centers. While these may cause short-term investors to panic over market uncertainties and make rash investment decisions, a long-term rational investor may be able to discover opportunities in turbulent times to add to their portfolios with investments that have declined in value.

Ever since man invented markets, one thing has remained constant: price volatility. Prices go up and they go down. Sometimes they go down hard. However, keep in mind that any short-term pain is a price that an investor pays for the long-term gain that the stock market, eventually, delivers.

■ Portfolio construction is crucial

A good portfolio is one that takes risk management into account, not one that favours an ad-hoc process of picking what's hot each year. Research by Dalbar Inc. has demonstrated that the average institutional investor, who invests based on a process, outperforms the average retail investor, who invests based on emotions[1].

As a long-term investor, you should not be spooked by the market's troubles of the day. However, you should recognize the fact that various sectors within the economy can and will be impacted at different times. As such, to benefit from the market and maximize returns at any given time, you must ensure that your portfolio is well diversified. This will include diversification in terms of asset class, geographic markets and investment styles. That way, when one component of your portfolio is hit by extreme downside volatility, you can take comfort in the fact that the resulting losses on your portfolio may be mitigated by returns from another component.

Asset class diversification does not promise protection from negative returns. What it offers is a cushion against major negative returns in volatile markets. That is because not all asset classes in a diversified portfolio are impacted in the same way by the market's fear of the day.

■ Stay focused on long-term objectives

Volatility in and of itself should be meaningless to the long-term investor. Of late, most investors have been overly focused on the current value of their investments. They should instead be concentrating on the value of their investments at some point in the future – i.e. the point at which they will need their assets for a down payment on a home, for college tuition or for retirement.

If you need to use your savings in the near-term, you should be in cash or a cash equivalent position, not invested in stocks. That way, you will not have to contend with volatility. For everyone else, the only thing that should matter is what your assets will be worth when you need them in the future.

[1]Dalbar Inc. Quantitative Analysis of Investor Behavior, 2003

So let's keep things in perspective as the markets react to news such as, global terrorism, credit crunches, technology bubbles and bank earnings. There may be more bad news and more volatility before we gain some clarity about the future strength of the economies. That however, does not mean that patient investors need to lose any sleep.

Stay positive. Yes, it's scary out there but, it's not all doom and gloom. Remember that this too shall pass.

Recall that in the 1987 stock market crash, the Dow Jones Industrial Average fell 22% in one day. Less than two years later though, it had recouped all of its losses. After five years it was up 41% from its pre-crash level and ten years later, it was up 253%. Similarly, a year from today, investors will likely have forgotten about the current crisis.

Resist the urge to check prices every day. Give yourself a break. Do anything to take your mind off the markets. In the meantime, you have the choice of taking advantage of others' panics and picking up your investments at cheaper prices. The world has not ended, and good sound investments managed by investment managers who have years of experience investing in volatile times will continue to shine.

> *"Investors repeatedly jump ship on a good strategy just because it hasn't worked so well lately, and almost invariably, abandon it at precisely the wrong time."*
>
> *– David Dreman*

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