Stockmarket rebounds, but is it for you?

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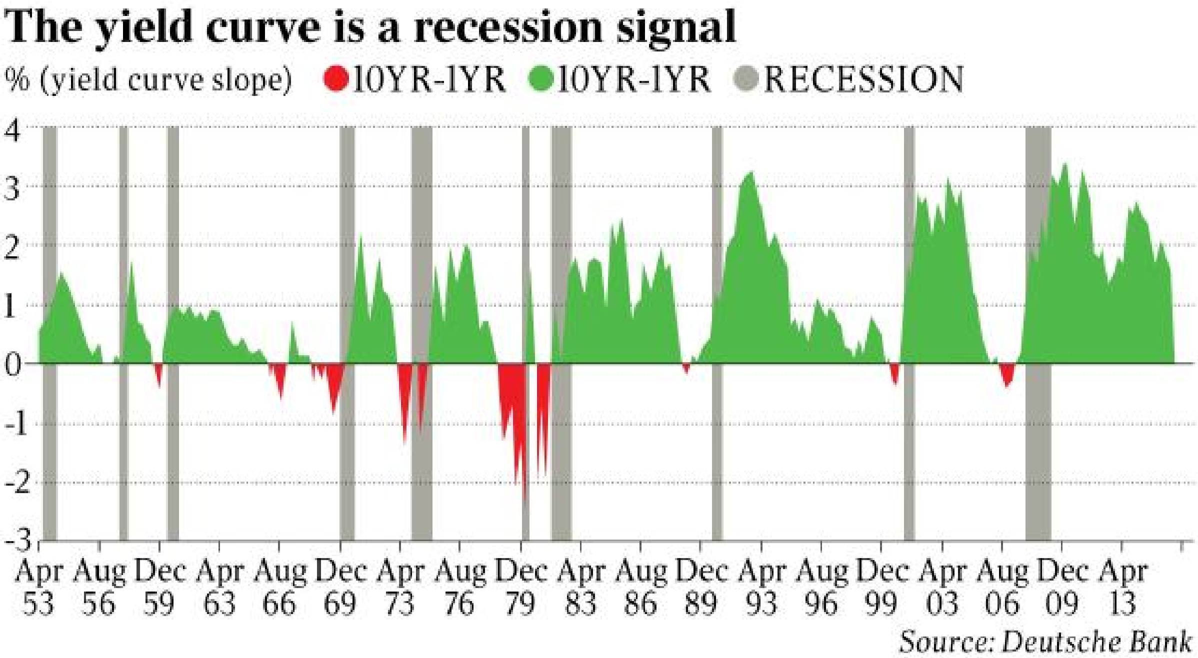
Australian shares have delivered an average 10pc return a year, but investors have to cope with the risks, uncertainties and volatility in holding shares.



Suddenly there are signs the sharemarket is alive again, with the ASX back over the 5200 mark.

It’s a good time to take a broader view on Australian shares. Over the long haul they have delivered an average return of 10 per cent a year. That’s before inflation or tax.

Even when long- term inflation — of 3 per cent — is taken out, the average share investor has enjoyed a return of 7 per cent a year.

Sounds good. But investors have to cope with the risks, uncertainties and volatility that come with holding shares. And they need to consider some key questions.

Will the trend return on shares contract from its traditional, exalted level?

How does an investor cope with the wider cycles sharemarkets go through?

How might investors handle plunges in sentiment, such as the one we witnessed in January?

In developing a strategy to cope with these issues consider these three points:

• **The longer-term return from shares has withstood many pessimistic phases**.

Many investors and commentators expect long-term real returns on shares — and on most other asset classes — to be much lower than in the past.

In part, that’s because of the effects ageing populations are predicted to have on patterns of work, saving, investment and government finances.

Also, in many countries, trend rates of growth in productivity have slowed. And a lot of companies are finding it harder to grow, or even to maintain, profits given the opportunities their customers now have to shop around.

A note of caution, however. Australian investors have often been confronted with predictions of modest long-term returns — in the recession in the early 1960s that was said to herald “the end of our post-war prosperity”, in the 1970s when oil prices rose sixfold, and in the 1990s when we were viewed as an “old economy” in a dot.com world.

And the terrorist attacks in 2001 led to lower expectations, here and abroad, that business and investments “would never be the same again”.

• **Sharemarket cycles never die.**

Too often, investors come to believe cycles in the economy and investment markets have been tamed. In fact, cycles — sometimes wide and sometimes mild — will always be with us. The reasons: we’re much affected by the moods of others, thus creating waves of optimism and pessimism; economic policies are often changed too much and too late; and credit flows alternate between flood and famine.

Investors should allow for the uneven returns, year-to-year, that will come from holding shares.

Investors might look out for turning points in the investment cycle — and for any good opportunities that might be offered for counter-cyclic investing. Above all, they should hold a sensible diversification of assets, including a good selection of interest-bearing assets that are safe and liquid.

Otherwise, they may have to sell core holdings from their share portfolio in depressed markets.

• **Learn to take the sharemarket's bumps and wobbles.**

At times, sentiment in sharemarkets swings widely. This can be because a major turning point in the investment cycle is at hand — but it can also be because markets are jumping at shadows. As Paul Samuelson famously quipped 50 years ago, investors needed to understand the US sharemarket had predicted nine of the preceding five recessions.

Naturally, many people working in share trading rooms worry about a bear market in shares each time share prices plunge. But investors should ask themselves whether the initial sell-off in shares is likely to be followed by a lengthy slump in share prices, or whether it is just a short-term wobble in response to market noise and market positioning.

If it's more likely the former — as in 2008 — the response should be to batten down the hatches and wait for the real bargains to appear. If prospects are the slump in share prices is a temporary wobble — as in the early months of this year and in 2011 — investors might use the opportunity to pick up shares cheaply.

It comes down to taking a view on the prospects of early recession. Among the useful indicators of a forthcoming recession are a sudden tightening in the availability of credit and a sharp rise in unemployment.

But the best forewarning of an imminent recession is given by the relationship between short-dated interest rates and longer-dated ones. The time to worry about an early recession — and thus a bear market in shares — is when short-term interest rates exceed long-term rates. And the chances of that happening in the next 12 months are, in my view, modest.

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