

RussellInvestor

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Helping you make informed investment decisions for your future



The costs of BAILING OUT OF THE MARKETS

So far this year, investors have faced significant volatility and steep declines in the markets around the globe. This attributed to massive equity fund redemptions by investors unable to weather the short-term upheaval.

It's during such uncertain times that investors tend to act as their own worst enemies as discipline is overcome by fear of the unknown. This is compounded with some investors switching funds, changing advisors, or altering investment objectives in a panicked response to changing markets.

How much does investing based on fear cost the average investor? Research reveals that panic costs an estimated 1.5% per year in "lost" returns.

This article addresses the challenges and costs that volatile markets can bring to investors' resolve.

The Cost of Investor Behaviour

Investment success results from effectively being able to buy low and sell high. While this is a concept easily understood, it is one that is difficult for individual investors to practice – simply due to investor behaviour.

Historically, redemption rates are at their highest levels when markets exhibit extreme negative behaviour - essentially selling out when the market tends to approach a low. Conversely, as market sentiment improves, funds tend to pour in as investors are, in effect, buying back in at a high. Figure 1 illustrates how fund flow is strongly correlated with market returns.

In January of 2008, for instance, the gloom surrounding Financials and the continued uncertain credit environment resulted in net changes in the total value of Canadian equity funds in the amount of $-\$11.8B$. At the same time the S&P/TSX Composite Index declined $-4.7%$ for the month.

Placing this into context, utilizing these monthly domestic equity fund flows also allows us to derive what the “average investor” would have achieved versus the S&P/TSX Composite Index over the past 13 years.

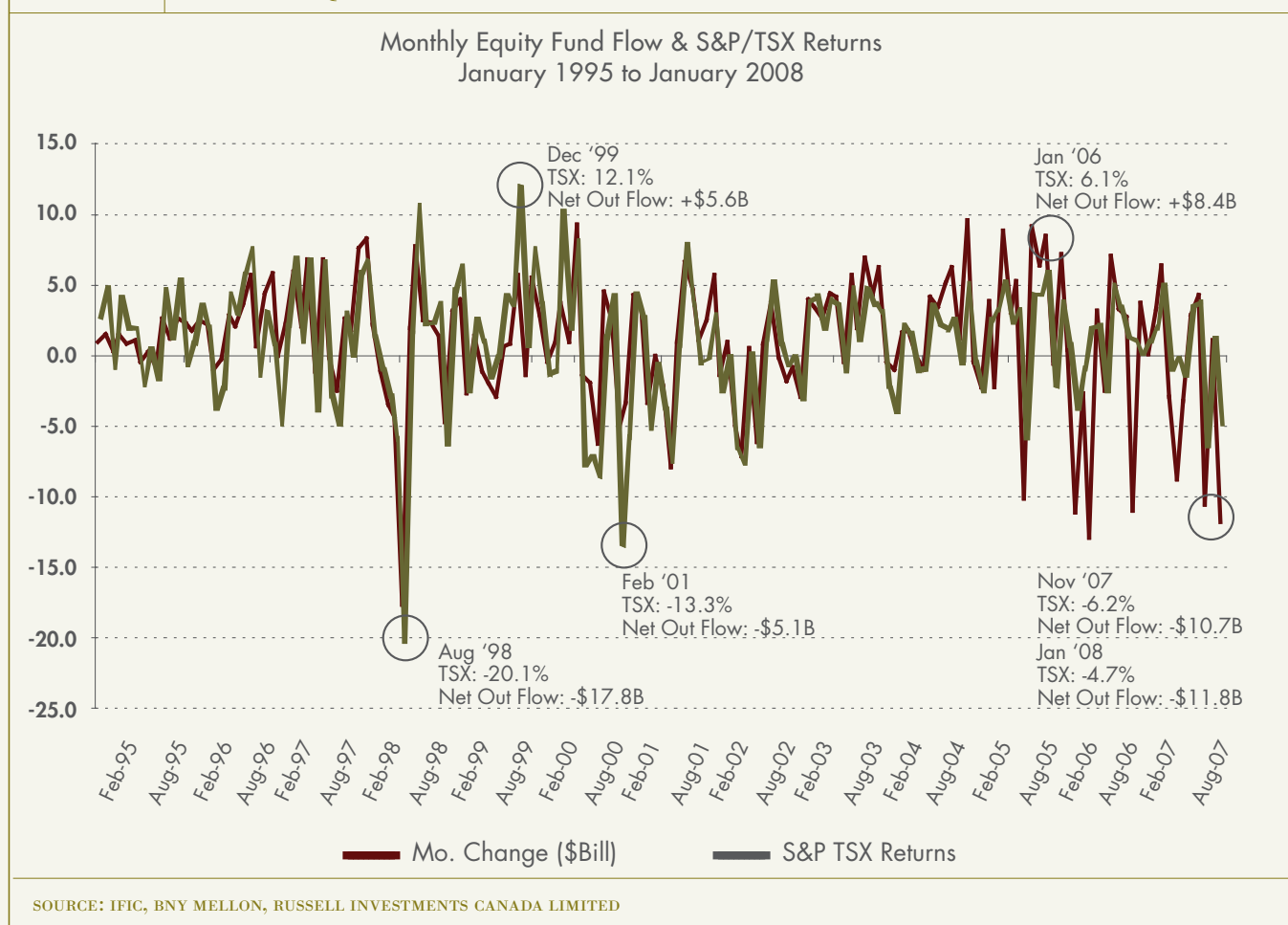
Figure 2, on the next page, reveals how inconsistent behaviour by the assumed average investor results in

an erosion of $1.5%$ on an annualized basis from passive benchmark like returns – a significant margin of error with even more drastic cumulative implications. Succinctly, the investor may have been better served by inaction alone.

The Cost of Missing Market Rebounds

Market extremes can lead to emotions which often cloud objective analysis. Here are two examples of memorable market downturns. It's important to look back at what happened during and after these market events, in order to understand the historical patterns between downturns and the subsequent market results.

FIGURE 1 MONTHLY EQUITY FUND FLOW



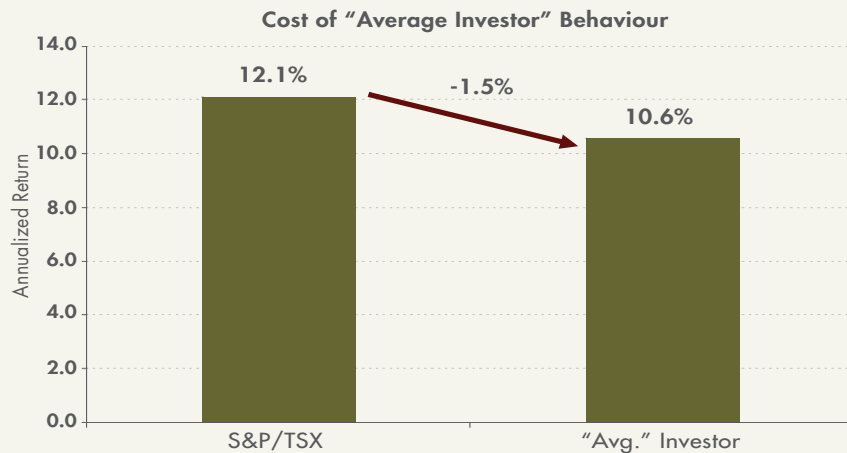
RECESSION & OIL CRISIS (1973-1974)

The oil crisis in the early 70's was memorable to many. There were line-ups at the gas station,

the U.S. stock market declined 45% in a year, unemployment was near depression era highs in some countries and there was double digit inflation, as purchasing power eroded around the globe.

Going into the oil crisis, the Canadian stock market had a respectable 81% return from 1970 to 1973. Then it all fell apart, due in part to the rising oil prices and commodity shortages. The equity market fell by -34% between 1974 and 1975. However, investors who bailed missed one of the epic rallies in Canadian equities – up 277% between 1976 and 1981. Markets have historically gone up more than down, so bailing is a losing strategy unless you can successfully time when to get back into the market – and most of us do not have a crystal ball to do so consistently (Figure 3).

FIGURE 2 COST OF INVESTOR BEHAVIOUR

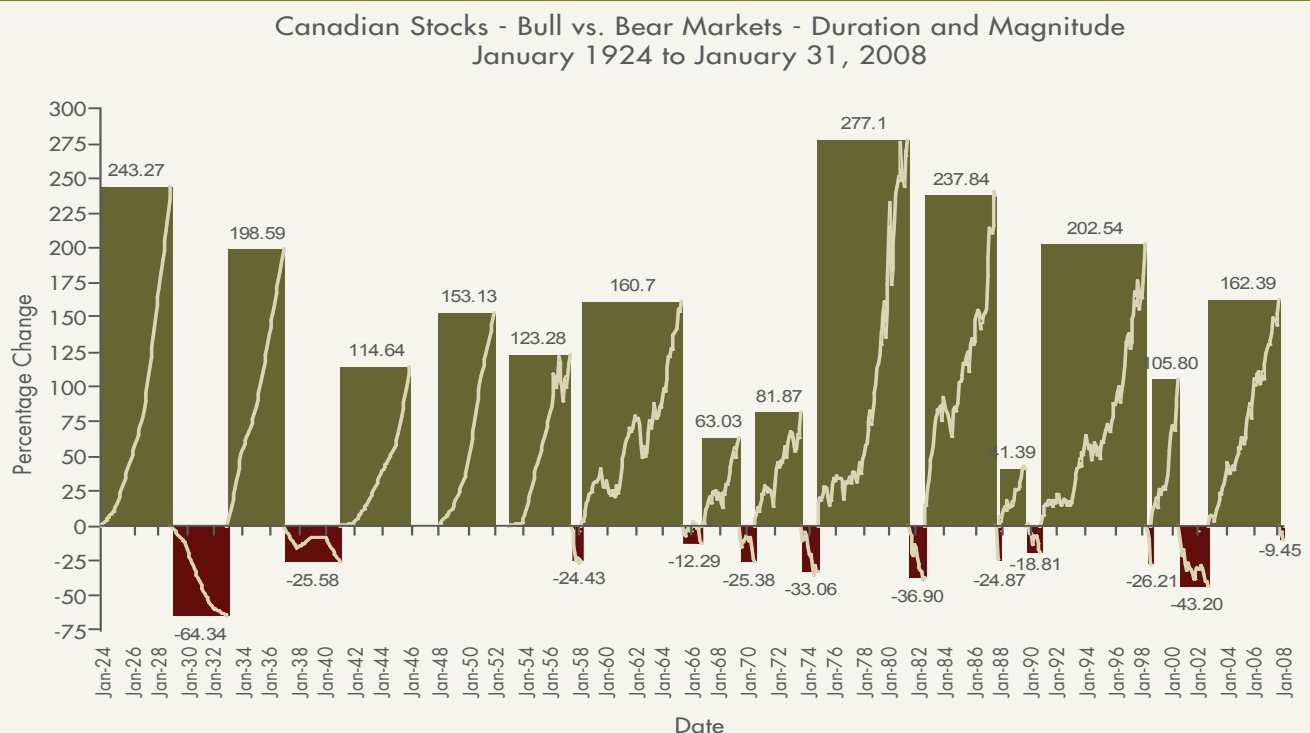


SOURCE: IFIC, BNY MELLON, RUSSELL INVESTMENTS CANADA LIMITED. RETURN WAS CALCULATED BY DERIVING THE INTERNAL RATE OF RETURN (IRR) BASED ON IFIC MONTHLY DOMESTIC EQUITY FUND FLOW DATA WHICH WAS COMPARED TO THE RATE OF RETURN IF INVESTED IN THE S&P TSX INDEX AND HELD WITHOUT ALTERATION FOR FROM JAN 1995-DEC 2007. THIS SEEKS TO ILLUSTRATE HOW REGULARLY INCREASING OR DECREASING EQUITY EXPOSURE BASED ON THE CURRENT MARKET TRENDS CAN SACRIFICE EVEN MARKET LIKE RETURNS.

THE TECH BUBBLE (LATE 1990's)

More recently, we all remember the late 90's and the "new economy" where technology and the Internet was king. The markets once

FIGURE 3 DOWN MARKETS HAPPEN, BUT THEY'RE OFTEN FOLLOWED BY UP MARKETS



SOURCE: RUSSELL INVESTMENTS CANADA LIMITED

again taught us that what goes up, disproportionately will come down.

The Canadian stock market fell -43% from 2001 to 2003. The litaney of the new economy became history and the markets pulled up their socks to see when, how, and what stocks would recover, after one of the longest growth rallies in history (Figure 3).

Once again, investors who exited the markets in 2001- 2003, likely missed the incredible rally that followed - with the market returning 162% over the next few years. The moral of the story again, is that stock markets go up more than they go down. The stable, committed investor wins by not bailing out.

Attributes for **Successful Investing**

Rather than trying to out maneuver the volatility in the markets, investors may be better off trying to navigate through it. As illustrated, there is a material consequence in the form of lost returns associated with rash movements in and out of the markets. Investors need to be well-equipped to absorb the shocks financial markets can deliver and would be best served by working with experienced Investment Advisors who are direct beneficiaries of the extensive research process Russell Investments utilizes.

While uncertainty can bring about risk, it can also lead to opportunity if this risk is meticulously reviewed and is appropriately distributed in a portfolio - a key attribute for successful investing and one that is employed by Russell.

In summary, with so many unknowns in the investment landscape, some investors can make the mistake of losing their discipline - becoming their own worst enemy. Russell's emphasis on manager research, risk management, and investment discipline buffers some of the costs associated with market uncertainty.

COMMISSIONS, TRAILING COMMISSIONS, MANAGEMENT FEES AND EXPENSES ALL MAY BE ASSOCIATED WITH MUTUAL FUND INVESTMENTS. PLEASE READ THE PROSPECTUS OF THE MUTUAL FUNDS BEFORE INVESTING. MUTUAL FUNDS ARE NOT GUARANTEED, THEIR VALUES CHANGE FREQUENTLY AND PAST PERFORMANCE MAY NOT BE REPEATED.

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