

Research Paper

Share market recovery profiles, updated December 2011

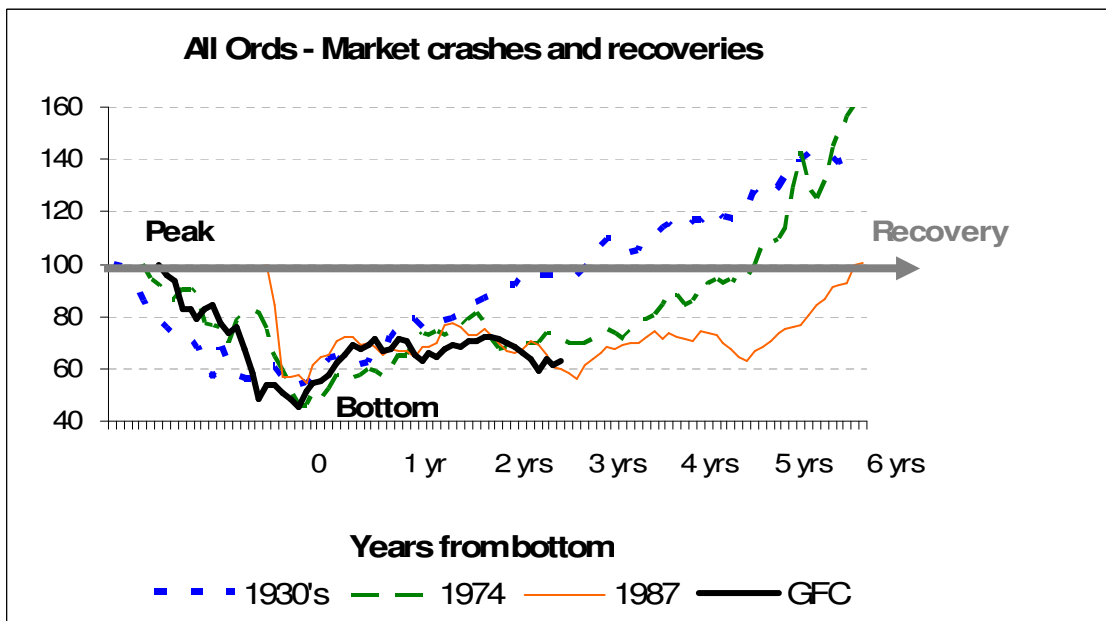
In our previous article about share market recoveries (published August 2009), we looked briefly at **what happened after the bottom was reached past share market crashes** in the Australian and overseas share markets. While we can't necessarily expect the recovery from the 2008/9 share market crash to match previous crashes, looking at what happened historically after previous ones can help prepare us for a range of outcomes in the short term and also to focus on the long term outcome.

We have updated the research in the previous paper to show how this share market recovery is tracking - to see if it's in line with our expectations. The chart below shows what happened in the Australian share market in the last three share market crashes and subsequent recoveries. This and the table below, show **that it took 3 to 6 years for the Australian All Ordinaries Index to return to its pre-crash level.**

The current recovery to date

As you will remember, our share market recovered strongly from its March 2009 lows. The Australian All Ordinaries Index rose 61% to its most recent high in April 2011.

Most of this increase occurred in the first 12 months after the market bottom. As you can see from the chart below, since then it has dropped again (-14%). While frustrating for investors, the chart shows that is a fairly normal path – similar to the recovery following the 1974 and 1987's share market crashes.



Indexes are re-based to 100 at the market peak before the crash and are for the ASX All Ordinaries price index (so do not include dividends).

The medium term prospects

These two slower past market recoveries still posted a full recovery within 6 years (when the coloured lines meet the horizontal grey line in the chart). So while Australian market seems to have been going nowhere for the past year or more, **if history is a guide, it should a some point in the next 3 or 4 years deliver some very good results.** Most likely, these will come in short, unpredictable gains.

With this potential for some good months ahead (perhaps not yet though), potential medium term returns look attractive. For instance, even if the Australian market takes longer to fully recover this time - say 7 years or until March 2016 - that translates to a return from now of 11%pa, plus dividends. And remember, currently, dividend yields are high, at about 7%pa grossed up for franking credits.

What were the returns over the recovery period from past Australian share market crashes?

	1930's	1974	1987	GFC
Market fall	-46%	-54%	-43%	-55%
Return needed to recover	86%	117%	74%	120%
Yrs taken to recover	3	5	6	?
Return, pa	23%	17%	10%	

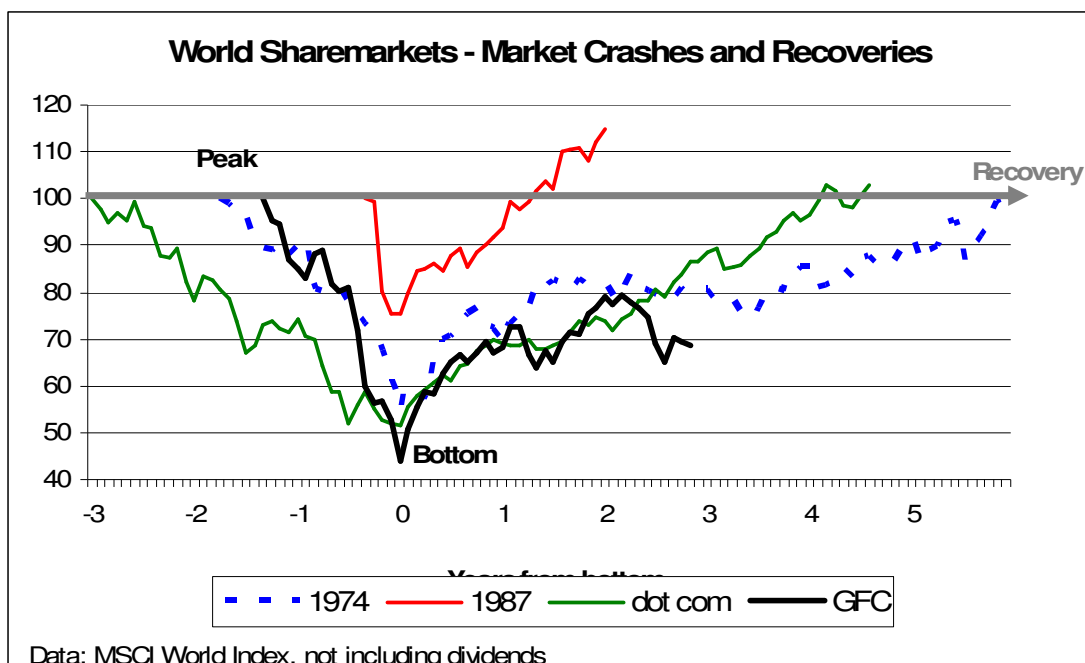
Returns are for the ASX All Ordinaries price index (so do not include dividends).

Overseas

The chart below shows what happened in the global share market (as represented by the MSCI Standard Core ex Australia index, local currency) in the last three share market crashes and subsequent recoveries. This and the table below, show that it took 4 to 6 years for the market to return to its pre-crash level for falls of a similar magnitude (1974 and 2001/2 dot com crash). Over these recovery periods, the global share market returned between 10%pa and 18%pa plus dividends.

The current recovery to date

From the market bottom until April 2011, the MSCI World Index was up 75% and the MSCI Emerging Markets Index was up 95%. These returns are those earned by local investors in their local currency and don't include dividends. In Australian dollar terms, an unhedged Australian investor will have earned less due to the rise of the Australian dollar. As in Australia, since April world markets have fallen – down 13% for the MSCI world Index and emerging markets down 16%.



Returns are for MSCI World ex Australia Standard Core price index (so do not include dividends).

If it takes another, say, 5 years for the overseas share market to recover this time, then returns from now would be 8%pa plus dividends to local investors. If over that period, the Australian dollar falls 20%, to say USD 0.85, unhedged Australian investors could earn an additional 5%pa currency return.

What were the returns over the recovery period from past overseas share market crashes?

	1974	1987	dot com	GFC
Market fall	-45%	-25%	-48%	-56%
Return needed to recover	81%	33%	94%	127%
yrs taken to recover	6	1.5	4	?
Return, pa	10%	21%	18%	

What about 1929?

We have left 1929 out of this analysis because the fall in the US in 1929 was significantly more severe than the recent fall, so could be expected to take significantly longer to recover. The returns prior to the 1929 fall were also significantly greater. In the 8 years prior to the crash of 1929, the Dow Jones Industrial Average rose 467%, then between August 1929 and June 1932, the Dow Jones fell 89%. It then returned 31%pa over the next 5 years, but it had not recovered at this point. It took until 1954 to completely recover.

Do all countries behave the same?

It is worth remembering that while the share markets for different countries tend to all fall at the same time; they do not always behave the same in the recovery phase. For instance, after the 1974 crash and into the early 1980's the US market had a long period of flat performance. However, the UK and Japanese markets delivered very good returns to investors.

Country selection can be quite important to your long term investment returns.

Short term risks

Whether it's before or after a share market crash, shares are highly volatile investments. As we have all recently experienced, short term returns can be significantly negative and very dependant on market sentiment.

In the short term, markets can fall or go sideways for what seems at the time like a long while. In the years after the share market crashes of 1974 and 1987, the Australian All Ordinaries occasionally pulled back 15% – 30% over a period of 6mth to over a year. There were only small falls (<6%) in the five years after the 1930's crash. The largest and longest (a year and a half) of these short term pull-backs occurred after the 1987 crash and this coincided with the recession we experienced in the early 90's.

Potential short term negative returns introduces a risk to people entering the market now. To mitigate this risk, we recommend investing over a period rather than all at once.

Conclusion

While the current share market is at best frustrating and at worst somewhat frightening in its volatility, the medium to long term return potential of a diversified share market investment looks attractive.

If the recovery this time behaves like the previous three post-crash recoveries, then medium to long term returns from shares from here could be in the 8%pa - 10%pa plus dividends range.

So what do you do?

1. Choose an allocation to shares you are comfortable to stick with over the medium to long term. For many, this could be less than what you felt comfortable holding in the past given both the current uncertain global environment and your recent experience with how risky shares can be (ie, they can fall 50% or more sometimes).
2. Stay relatively close to this long term desired asset allocation to shares. By significantly reducing your exposure to shares when markets are falling, with a plan to increase in the future, you risk missing the good periods or going back in right before another fall. Unfortunately the good months never arrive with advance notice, likewise the bad ones.
3. Given that the market could go nowhere for another year or more, we think that it is important to invest in shares that deliver reliable dividends.
4. Select your overseas country exposure carefully. Most overseas share funds manage to a benchmark that is 54% weighted to the US share market. We think that level of exposure to the US in your overseas share allocation may not result in the best medium to long term returns.
5. Remain unhedged for part or all of your overseas share investments to benefit from a potential future fall in the Australian dollar.