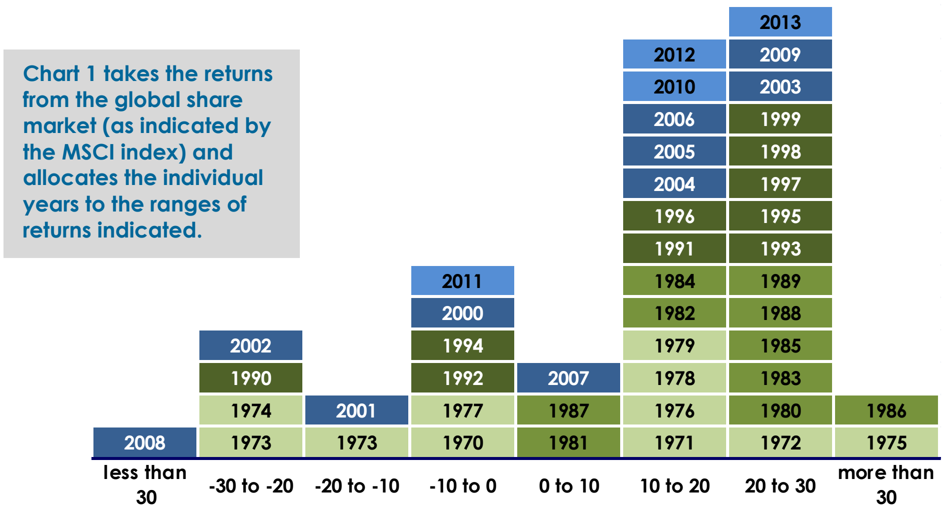
Investments sometimes go down in value and need time to come right

When we look back at the past returns from the share markets, we can observe that one in every three to four years the markets go down and the returns are negative.

Chart 1 Global share market returns 1970 to 2013



Source: MSCI (local currency)

We can also observe, that sometimes (normally about four times each century), the share market halves in value (i.e. $100 becomes $50). However, history shows that when the market halves, given time, the market recovers and goes on to reach new highs, before the patterns of falling and rising is repeated. The most recent period when the share market declined 50% occurred between October 2007 and March 2009 during the global financial crisis. Since then, the New Zealand and global markets have recovered and are now generally at all time highs – see chart 2.

Chart 2 NZ $100 invested 30 June 2007 in the global share market (MSCI index) and the NZ market (NZX 50 index)

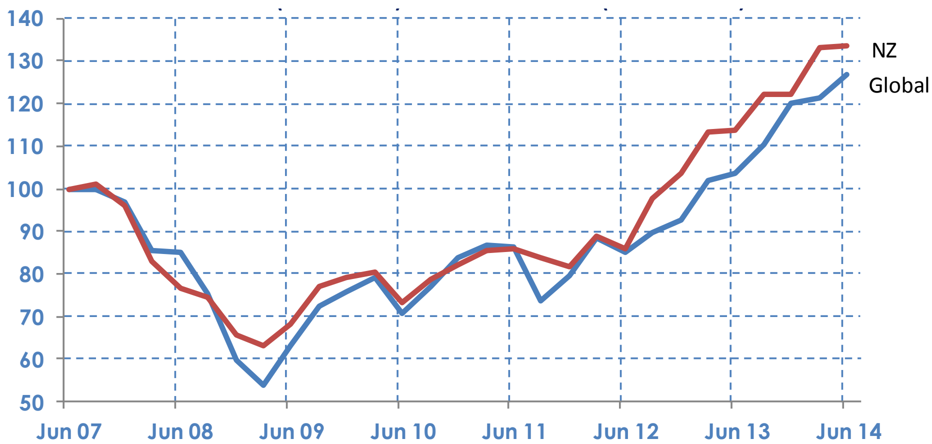


Chart 2 highlights the share market decline between October 2007 and March 2009. At the time there was a lot of uncertainty and cause for concern. In response, some investors sold shares and moved their savings to the perceived safety of "cash". This may have stopped the short term pain but also locks in the initial loss. It is up to each investor to decide if this is right for them.

Using NZ shares as an example, if an investor switched from shares to cash after the share market had fallen say, 10%, 20%, 30% or 40% and then stayed in cash, their original $100 savings, at 30 June 2014, would have become:

Switch to cash after fall in NZ share market of:	Savings at 30 June 2014 ($)
10%	$113.50
20%	$98.70
30%	$82.90
40%	$72.90

In contrast, if the investor had not switched to cash and had maintained their investment in NZ shares, their total savings at 30 June 2014 would have been $133.40. By switching to cash, they would have avoided the pain of the full decline, but also missed out on the eventual recovery.

While the investors who acted quickly, e.g. on a 10% fall, would now be ahead of their original $100, those that took longer to act would still be down. Therefore, for most investors, the better long-term strategy, would have been to stay in shares and tolerate the period of negative returns.

Conclusion

When you save, you have to decide how to invest your savings. One of the key drivers of how you choose to invest is the nature of the return you want to receive. Some want to invest to get the highest return, but most would prefer to get the return that helps them achieve their goals.

If it is important that each month you get a positive return and see your savings rise in value, then the best choice is to invest mainly in "cash" assets. This will normally produce a positive return, but is not always guaranteed to. However, it is also expected to produce the lowest average return over the next 20 years; probably around 3.25% after-tax.

If you want to have a higher average return and time is on your side, you have to invest some of your savings in bonds, property and shares, and be willing to have a low or negative return over some shorter periods. Therefore, to get a higher return, you need to be willing to be patient and wait when things do not go as planned. It's crucial to have time on your side when the markets go down as the types of assets that produce the higher average returns, go down as well as up.

History shows that when it comes to the share market, it is important to have time. This also means that it is important to have some cash, or cash and bonds, to meet the expenditure that you will incur in the immediate future, so the shares do not have to be sold if they decline in value. This way you can leave your share investments alone and wait for the recovery. The amount of cash, or cash and bonds, should equal the expected expenditure that needs to be funded from the investment returns and capital over the next 10 to 12 years, i.e. over the period while you wait patiently for the markets to recover. For example, if you have $100,000 invested and you think that you will need to spend $40,000 in the next 10 to 12 years, then you might hold $40,000 in cash and bonds and the balance in shares and property, but still need to be comfortable with the likely ups and downs you will experience from the shares and property.