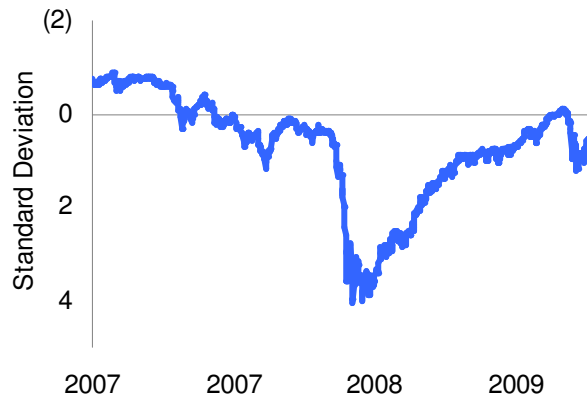




## When fear comes to town

In this Point of View, AXA's Chief Investment Officer Mark Dutton notes that investor risk appetite has recently been dominating the markets. Investment strategies based on 'fundamentals' will need different conditions to deliver good returns.

**Figure 1: Global risk aversion indicator\***



**Figure 2: Global sharemarket**



- Figure 1 incorporates equity index-implied volatilities, bond spreads, currency index-implied volatilities and equity mutual fund flows. Source: Bloomberg, Datastream, Investment Company Institute and AllianceBernstein. Figure 2 MSCI World Index ex Australia in local currency. Source: Datastream. Data as of 30 June 2010

### In brief

- When fear comes to town, *all* risks are out of favour and safe options become expensive.
- Behind the scenes, the 'fundamentals' are getting better, not worse.
- Investment strategies based on 'fundamentals' have not failed. They should deliver when risk aversion eventually subsides.

### Risk is in the driving seat – for now

In recent times, the weather in the financial markets has been extreme. Interpreting markets in these conditions can be very misleading. The explanation will not be found in the 'fundamentals'. Investor risk aversion is driving market performance.

Figure 1 illustrates a composite of indicators of investors' willingness to invest in risk.

It shows that while risk aversion has come back from extreme levels reached during the GFC, new waves of risk aversion have dominated markets over the past few months.

When looked at against the global sharemarket, shown in figure 2, it is clear there has been a very close relationship between the level of risk tolerance, and the level of the market.

### Nervous times

In May and June, fears rose. European sovereign debt contagion concerns increased, as did fear of double dip recessions, and a possible slowdown in China. Risk tolerance fell, and so did the markets.

July fared better. Fears subsided, and risk based markets rose.

This reprieve was short lived. In August, anxiety regarding Europe's outlook and China's imbalances returned, along with the increasing likelihood that the US will require further stimulus.

### When fear comes to town

When fear comes to town all risks go out of favour. Share prices fall, credit margins rise, the value of almost anything with leverage falls, commodity prices fall, and 'risky' currencies, including the Australian dollar, also tend to fall.

In this kind of environment it looks like the fundamentals don't matter. And to add to concerns investors can see that many assets become highly correlated, so it looks like diversification doesn't matter either.

These doubts lead many to flee sound strategies at exactly the wrong time, and invest in assets seen to be 'safe', which then become expensive.



## Will the rally come back?

The recent bout of extreme risk aversion has diverted attention from the fact that many of the 'fundamentals' are getting better, not worse.

Consider some of the key ingredients needed for a sustainable rally in the sharemarket:

- Low prices tick
- Positive earning expectations tick
- Results that meet or beat tick
- Normal volatility not yet

Opportunities now exist in both the Australian and global sharemarkets to invest at attractive prices in quality assets that would normally command a premium.

On a forward price to earnings basis, the Australian sharemarket is trading at a 17 per cent discount and the global sharemarket is trading at a 24 per cent discount.

Dig a little deeper and it is remarkable the number of relatively cheap stocks available, which do not require a sacrifice of quality. Or the number of high growth stocks which do not command a premium price. These anomalies must eventually realign.

## Profit results look positive

We are now largely through the June quarter reporting season. Generally, reported profits have met expectations. In the US market for example, around 85 per cent of the companies reported to date have met or exceeded profit forecasts.

In Australia, results are a little more mixed, but more than 70 per cent of companies that reported have met or exceeded earning expectations.

There are still doubts about the outlook for profits next year, but so far, the market forecasts previously viewed as 'optimistic' have generally been met or exceeded.

## What this means for investors

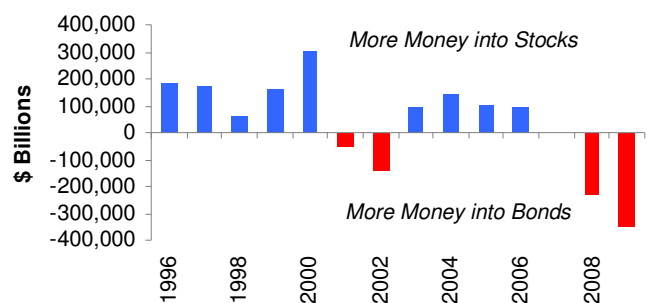
The fundamental drivers of asset class returns, or features affecting value will ultimately be reflected in prices, but not when markets are preoccupied with risk.

The perception that fundamental based strategies aren't working adds to already heightened levels of investor concern, and reinforces the destructive investor behaviour that we have seen repeatedly through previous cycles.

Figure 3 below shows the pattern of investment flows into US mutual funds. During bull markets more money flows into equities than bonds. When markets fall, money flows out of equity markets and into bond funds.

The result is a 'buy high' and 'sell low' strategy – a sure way to destroy value. This 'flight to safety' behaviour has been even more pronounced this cycle.

Figure 3: US Mutual Fund Flows



\*Mutual fund information excludes hybrid funds. Source: Investment Company Institute and AllianceBernstein. Data as of 31 December 2009.

Long term investors are generally exposed to fundamental factors. Distortions created by the dominance of a single factor, such as risk aversion, can last for extended periods, but not forever. Investment in fundamentals pays off if given the time to perform.

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