

The volatility continues...

The week got off to yet another volatile start today, as news filtered through that US investment banking giant Bear Stearns had pretty much collapsed due to subprime woes, forcing them to sell to rival JP Morgan. That news, together with a surprise 0.25% rate cut in the US, rocked global markets, including local shares.

While the US Federal Reserve will be officially meeting later this week, with the market expecting a 0.75% to 1% rate cut, interest rates here at home are likely to go up again as the Reserve Bank again attempts to dampen our booming economy.

Strangely, while our economy is plugged into the growing fortunes of China and Emerging Asia our sharemarket remains stubbornly reliant on Wall Street. While this disconnect won't last forever, in today's world, what happens in the US still remains important to Australia.

All very interesting, but in the end, whether your goal is to maximise wealth or ensure that your money lasts through retirement, navigating this difficult period will require patience, faith and a degree of bravery - we've been here before.

-Rick Maggi

Keeping your cool in a tough market

With every dip in the Dow or the ASX, that inner voice urging you to sell gets louder. Here are three reasons you shouldn't listen...

Reason No. 1 – Your brain is wired for panic.

Don't give in. Pros have all sorts of clever computer models for assessing risk. But even those brilliant machines misjudge risk from time to time (like in the US subprime meltdown).

So how can the rest of us expect to be right on risk when

all we have to work with is that carbon-based computer we keep between our ears? "Most people just can't think about risk in an analytic way", says Paul Slovic, a University of Oregon psychologist and an authority on how we assess risk. "The average person goes by gut feelings".

As behavioral scientists have proved, those feelings are notoriously unreliable in a market like this. Part of the problem is that your brain evolved to feel the pain of loss more acutely than the pleasure of gains.

That means that normal human reaction in a downturn is to turn fearful and sell – even though risk is lower than it was when stocks were higher and the rational move would be to buy.

"We always say "buy low and sell high", says John Nofsinger, a finance professor at Washington State University and author of "Investment Madness: How Psychology Affects Your Investing." But after the market has gone down for a while, the 'buy low' option is just not emotionally available to most people."

Obsessing over every bit of market news only raises the odds that you'll overestimate risk, according to behavioral economist Richard Thaler of the University of Chicago. The more often you check stock prices, he found, the greater you perceive your risk to be.

Prices move up and down pretty much constantly. If you're watching that activity minute by minute on your PC or TV, your brain gets the message that it's dangerous out there.

A simple, effective way to lower your anxiety: In Thaler's experiment, the subjects who perceived the least risk were those who checked their investments no more than once per year.

Reason No. 2 – You see safety in the herd.

It's an illusion. Faced with uncertainty, your instinct is to follow the crowd. Bad idea.

"The herding tendency clouds your judgement", says UCLA finance professor Subra Subramanyam. "If others are selling, you'll be prone to ignore your own assessment and sell as well." Economists dub this progression "information cascading". You might call it a lemming parade.

The record of mutual fund (superannuation fund) cash flows shows that the crowd's investing moves are a reliable indicator of what not to do.

The great manager of FPA Capital fund, Robert Rodriguez, notes that the largest fund in 2000, as stocks were peaking, was growth star Fidelity Magellan. Three years later the new darling had become bond fund Pimco Total return, just as bond returns peaked. "You can't make this stuff up", he marvels.

Today's fund cash flows suggest that you should buy stocks, since stock funds saw a net \$44 billion withdrawn in January.

Sure, it's not easy to hang on to stocks when everyone around is bailing, but if you do, history suggests that you won't regret it.

Reason No. 3 – You underestimate the risk of being out of stocks.

These days it's helpful to remind yourself of this: In the long run the risk of missing stocks' upside poses a graver threat to your wealth than taking hits on the downside does.

There's no denying that the big one-day drops we've seen recently are no fun, but if you hang in, the math works in your favour.

"Stocks go up and down", says Stephen Wood, senior portfolio strategist at Russell Investment Group. "to make money you need to capture their upward movements. The only way to do that is to stay invested in dicey times."

Don't kid yourself that if you flee stocks now, you can slip back just in time for a rebound. Years of data and volumes of research have proved that not even the pros can time the market with any consistent success.

Focus instead on the fundamentals. When the market plunges, so too do price/earnings ratios. And the cheaper you can buy, the better your chances of making money in the future.

For proof, consider the crash of October 1987 and its aftermath. Had you owned an S&P 500 index fund, you would have lost 23% during that month, including a stunning 21% on Black Monday, the 19th.

Had you sold, you would have locked in that loss. But had you stuck it out, you would have gotten back to even in 20 months. And then you would have participated in the great bull-run that followed, racking up an annualized 15% return over the next 10 years.

Sticking to your guns was psychologically no easier 20 years ago than it is today; but the results suggest that the investors who will look the smartest in a few years won't be the ones who are now jumping out of stocks and cashing-up.

-Excerpts taken from Money Magazine

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