Dimensional

OUTSIDE THE FLAGS

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Uncommonly Average

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Ask a farmer about average rainfall figures and he's likely to look at you sceptically. Knowing how actual rainfall varies from year to year, farmers will carefully manage their crops and irrigation. It's a lesson many investors could learn as well.

Staying disciplined when markets are volatile is easier once you accept that references to "average" annual returns, like rainfall, can mask a wide range of possible outcomes.

For instance, from 1980 to 2018 the Australian share market delivered an average annual return of nearly 13%. But in only four years over that near four–decade period have actual returns been within two percentage points either side of that average.

In those 39 years, the local market has fallen in 11 calendar years and gained in 28 years, or more than 70% of the time in other words.

The biggest one–year fall was during the global financial crisis of 2008, when the S&P/ASX 300 index fell nearly 40% on a total return basis. The biggest one–year gain was in 1983, when the market rose nearly 70%.

Exhibit 1 shows that only in four years—1996, 1997, 2016 and 2017—has the local market's annual movement been between two percentage points either side of the near four–decade average annualised return of 12.94%.

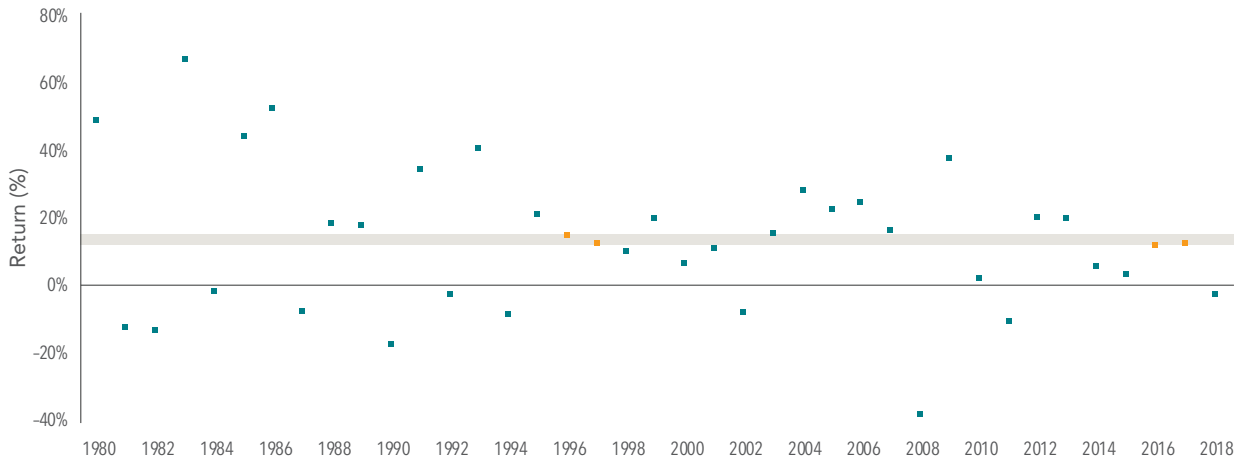
Dealing with volatility is part of the price investors pay for the returns on offer from equity markets. Those returns are unpredictable from year to year, making it near impossible to time the market. This means the only way of securing the long–term average returns on offer is staying in your seat.

The benefits of a long–term focus can be seen in Exhibit 2. This shows you the historical frequency of positive returns from Australian shares over different rolling periods.

This is a way of comparing returns for overlapping holding periods, starting from different dates. So, in this case, the first period starts in January 1980, the second in February 1980 and so on. In this case, we are projecting one year, five years and 10 years forward from each starting point.

The chart shows you that one–year returns on a rolling basis were positive 77.5% of the time in our sample period from 1980 to 2018. This increased to 95.6% over five–year periods and 100% over 10–year periods. (By the way, just because the 10–year rolling period performance in this relatively short sample has always

Exhibit 1: S&P/ASX 300 Index (Total Return) Annual Returns
1980–2018



In Australian dollars. S&P/ASX data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Indices are not available for direct investment. Index returns are not representative of actual portfolios and do not reflect costs and fees associated with an actual investment. Past performance is no guarantee of future results. Actual returns may be lower.

been positive doesn't mean it will always be so. In the US, for instance, where we have data going back to the 1920s, there have been longer periods when there was no market premium.)

What this all means is that just being aware of the range of potential outcomes in markets year to year can help you remain disciplined, which in the long term can increase the odds of having a successful investment experience.

Aside from discipline, another way of dealing with volatility is diversification. Just as farmers deal with variable rainfall by planting different types of crops, investors can manage volatility by spreading their bets.

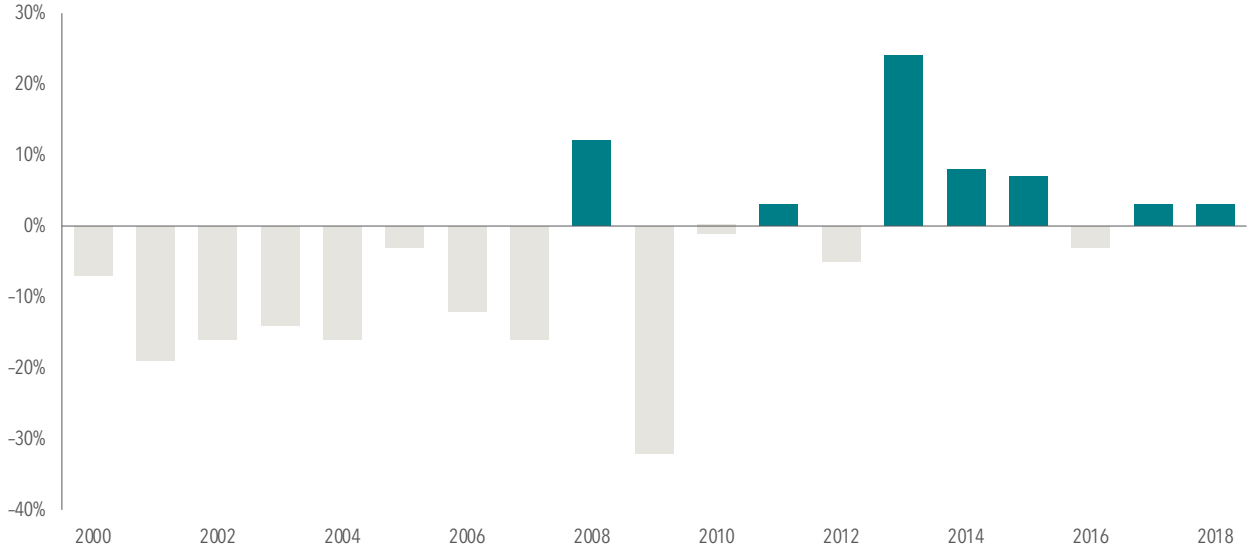
Exhibit 3 compares the return of Australian shares over the rest of the world from 2000 to 2018. The result is the gap between the two. A negative number means Australia outperformed the rest of the world. A positive means the rest of the world beat Australia.

Exhibit 2: Frequency of Positive Returns in the S&P/ASX 300 Index (Total Return)
Overlapping Periods: 1980–2018

In Australian dollars. From January 1980–December 2018, there are 349 overlapping 10-year periods, 409 overlapping 5–year periods, and 457 overlapping 1–year periods. The first period starts in January 1980, the second period starts in February 1980, the third in March 1980, and so on. S&P/ASX data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Indices are not available for direct investment. Index returns are not representative of actual portfolios and do not reflect costs and fees associated with an actual investment. Past performance is no guarantee of future results. Actual returns may be lower.

Exhibit 3: Australian Shares Vs Global Shares

Return differences of the MSCI All Country World IMI Index (net div.) minus the S&P/ASX 300 Index (Total Return), 2000–2018



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So, you can see that Australia did very well in the early years of the millennium, compared to other markets. You may recall this was the time of the China–led resource boom. More recently, Australia has lagged other markets.

The point of this is to show that you can lessen your reliance on the year–to–year performance of the Australian market (which after all only makes up about 2% of the world market) by spreading your investments to include international markets.

Diversification is a way of reducing the bumpiness of returns and of increasing the reliability of outcomes. This way you become less exposed to one market or one or two dominant sectors, which in Australia's case currently are resources and banks.

In summary, the notion of "average" returns can be misleading. It's wise to understand and be prepared for the range of individual outcomes that makes up that average.

You can deal with the ups and downs in two ways. Firstly, by taking a long–term view and remaining disciplined, you are more likely to experience that average return. Secondly, you can diversify across countries so that you lessen the impact of big swings in any one market.

Of course, this still doesn't guarantee there won't be investment droughts, but this may make it easier for you to stick with your plan and reap the harvest in the end.

(See a shorter version of this article on our public website Perspectives blog here.)

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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