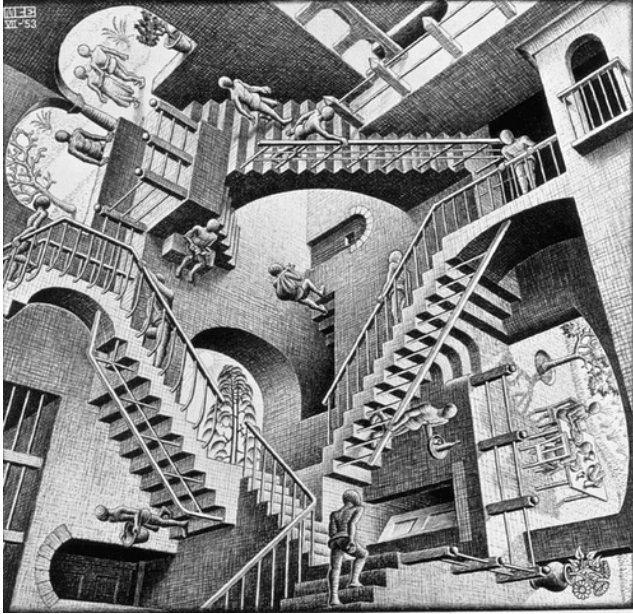
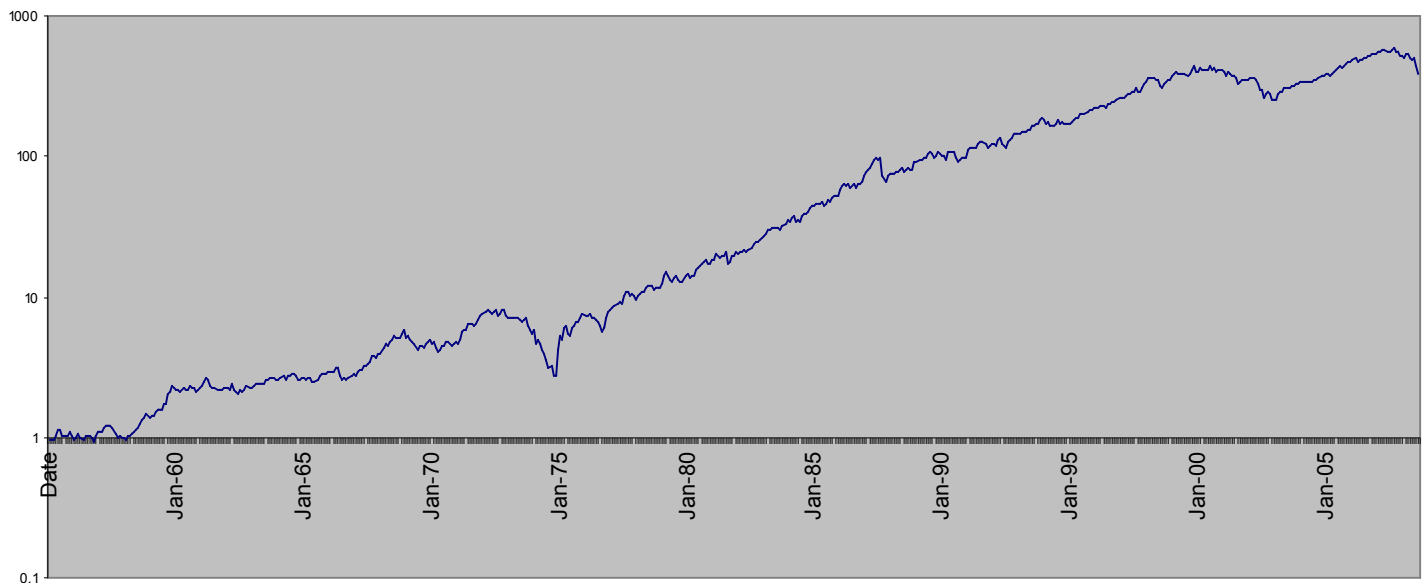
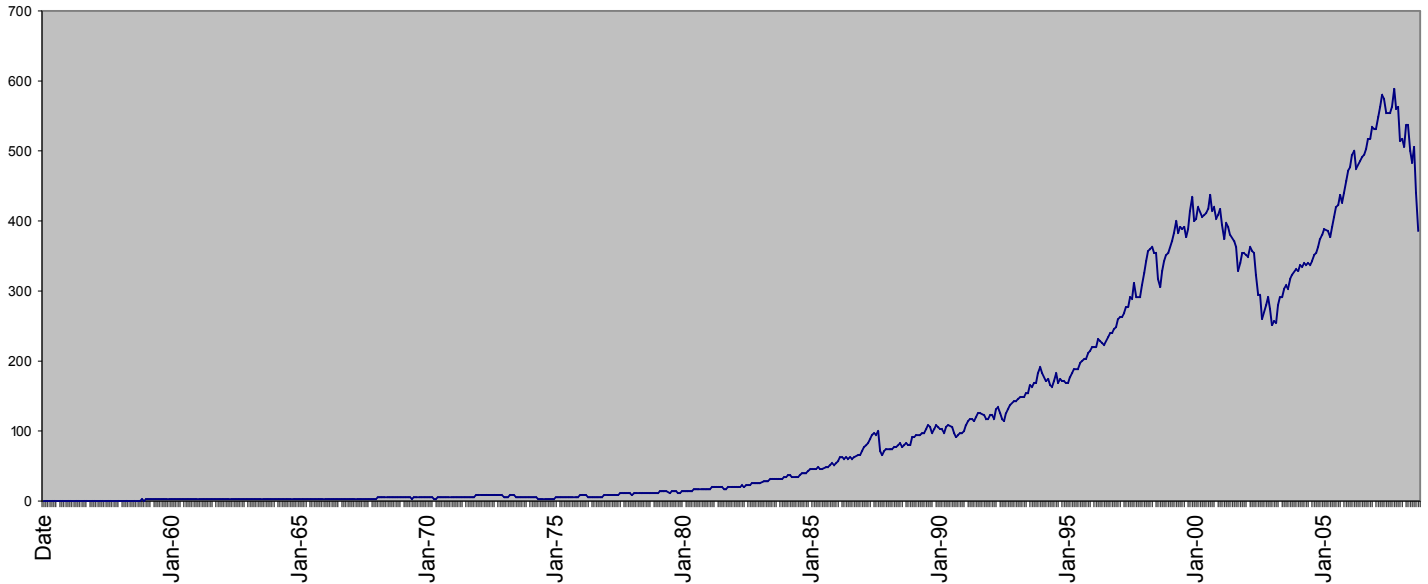


# A matter of perspective



What do you see in the picture ? You know an optical illusion is playing a trick on your mind but it is impossible to figure out. Investment markets can sometimes be a bit like that, and it is important to remember that perception is often very different from reality. Now take a look at the two charts below . They each show the performance of an investment market over time. Can you tell which produced the best return? Which was riskiest? Which one would you rather be invested in?

Amazingly, they both illustrate exactly the same data, but—and this is the point—from a different perspective: the FTSE All Share index from March 1955 to the end of October 2008 (the longest period possible). One uses linear scale (which is what is normally used and everyone expects to see) while the other shows a logarithmic scale.



The linear scale on the first chart is very helpful for showing just how important compound growth is (i.e. growth on the growth on the growth on the.....) over long periods of time. Keeping your money invested really has paid off—in spades—in the long run. On the other hand, it looks as if recent market conditions have been very bad; much, much worse than events in the distant past, which on this chart appear almost insignificant.

In contrast, the log scale smoothes out the long term benefits of compounding and allows recent fluctuations to be seen in the same context as earlier events.

Look at the first graph again; you should see that the period from April 1972 to November 1974 barely shows at all whereas the line appears to have fallen off a cliff in the last year. However, if you turn to the second graph you can see clearly that the early 1970's suffered a much more severe crash than we have seen at any time before or since. The last twelve months do show as a very poor period for markets but their significance is much less than the first (more common) graph would suggest.

The charts make a very important point about human nature—we tend to focus much more closely on, and attach far greater importance to, recent events than distant history. It is this tendency that often leads to panic and confusion and inhibits rational judgement.

This trait of human nature is what causes us to take decisions emotionally, whether positively or negatively. Investors piling into “dot.coms” in the late ‘90s, or into property in recent years, are doing so “because it’s different this time”. They forgot the lessons, and the finger-burning, of earlier corrections.

The table below puts the performance of the FTSE All Share into perspective by identifying all the periods from inception of the index where the market fell by at least 10%. It also shows how long it took to fall from peak to trough, and how long it took

Start Month	End Month	Number of Months Peak to Trough	Total Fall	Recovered to Previous Highest level	Number of Months to Recover
Apr-72	Nov-74	31	66.48%	Mar-77	28
Aug-00	Jan-03	29	42.90%	Sep-05	32
Oct-07	Oct-08	12	34.36%	???	???
Sep-87	Nov-87	2	33.81%	Jul-89	20
Jan-69	May-70	16	30.03%	May-71	12
Jan-76	Oct-76	9	27.36%	Jan-77	3
Apr-61	Jul-62	15	22.14%	Oct-63	15
Jun-57	Feb-58	8	20.59%	Sep-58	7
Jul-55	Nov-56	16	18.30%	Apr-57	5
Jun-66	Oct-66	4	17.71%	Jun-67	8
Dec-89	Sep-90	9	16.80%	Feb-91	5
Aug-81	Sep-81	1	16.36%	Jan-82	4
May-98	Sep-98	4	15.52%	Feb-99	5
May-92	Aug-92	3	15.20%	Nov-92	3
Jan-94	Jun-94	5	14.64%	Jul-95	13
Apr-79	Dec-79	8	14.42%	Jun-80	6
May-75	Jul-75	2	13.76%	Sep-75	2
Sep-77	Feb-78	5	11.95%	May-78	3
Sep-64	Jun-65	9	11.13%	Oct-65	4
Apr-84	May-84	1	10.41%	Sep-84	4

to recover. Eagle eyed readers may notice that it took until March 1977 for the market to recover to the same level as it had enjoyed in April 1972. However, there was actually a mini recovery followed by a further fall of almost 14% from May to July 1975. The market recovered to the May 1975 level by September of that year even though it took until March 1977 to fully recover to April 1972 levels.

You can see from our FTSE Top of the Flops chart that the current market fall is sitting at number 3 in our top 20. Although it is still possible it could make it even higher up the list before the recovery begins, it seems highly unlikely, even with the current

uncertainty surrounding banks, that we will see a crash of 1970's proportions this time round.

Trying to time markets from charts, diagrams and past history is an accident waiting to happen. It gets even worse when trying to predict the success or otherwise of individual shares, but there are plenty of pundits out there only too willing to speculate. The magazine Fortune is one example. Every year Fortune publishes an annual retirement guide full of tips for investors to help them retire rich.

In 1999 they published their tips for the 10 companies “with the size, stability and earnings power to carry investors through whatever the market throws their way in the decades to come.” These recommendations were based on “both outside experts and in-house quantitative analysis.” So what did a portfolio that can't fail to beat the market look like in 1999?

The table below shows the recommendations and the subsequent performance of each company between 13<sup>th</sup> July 1999 and 30<sup>th</sup> September 2008. It just goes to show even the best minds on Wall Street can't see the future no matter how much they tell us they can.

Initial Investment	Equally weighted portfolio \$100,000	
	Change In Value	Value of \$10,000 invested
AIG	-94%	\$561
Bristol-Myers Squibb	-59%	\$4,073
Cisco	-38%	\$6,161
Ford Motors	-77%	\$2,321
Home Depot	-33%	\$6,668
IBM	-8%	\$9,216
Johnson & Johnson	70%	\$17,005
MCI World Com	-100%	\$0
Tyco International	-78%	\$2,220
UAL Corp	-100%	\$0
		<hr/>
		\$48,224
S&P 500	-16%	\$83,580

Source: YahooFinance.com adjusted for splits, spinoffs and dividends

If an investor had placed \$10,000 in each of the 10 top tips they would have seen their \$100,000 investment slashed to just \$48,224 whereas if they had tracked the S&P500 index they would still have \$83,580 of their initial investment (both figures ignore the effect of charges). Clearly this was not a good time for any equity investor, as the initial investment came just before the technology bubble burst and the stock market crash of 2000 started. It also includes the events of the last year. What it does show is that, despite what many pundits may currently be saying, it is during difficult times like these that taking a well diversified approach to investment really helps. Investors trying to pick the best bargains at the moment may end up getting their fingers burned by buying a basket of junk. Trying to beat the market is a risky game best played by people who can afford to lose because they are gambling with other peoples money.

It is worth remembering that even allowing for all the various market crashes over the last 50+ years (including the current situation) the FTSE All Share index would have provided investors with a return of 12%pa from March 1955 to the end of September this year assuming dividends were reinvested.

The message, as always, is: get your risk profile right, diversify away as much risk as you can, hold on for the long term.

Discipline is key!