Investment Strategies For a Volatile Market

There are many ways you can make your money work for you.
You can put it in a savings account at a bank or a trust company, a term deposit, or in a guaranteed investment product. While these investments are secure, the interest, or rate of return you receive may be lower than the long-term potential of other vehicles. In some cases – such as in a savings account – your expected rate of return might not even keep up with inflation.

Many people turn to investing for long-term return potential – especially when they are saving money for a safe and secure retirement. For long-term investing, stocks have proven to be good investments. ***But how can stocks be a good investment when the market moves up and down?***

What about stock market crashes?

Market volatility is a fact of life when it comes to the markets, but history has shown that the stock market has spent much more time moving up than down. That is why stocks are considered a good investment over the long-term.

According to a study by the University of Pennsylvania's Wharton Business School,* if you threw out the best and worst 10 percent of stock market results since year end 1870, in rolling calendar year periods of 5, 10, 20, and 30 years, you would clearly see the power of long-term investing. The Wharton School study showed 5-year returns ranging from 0.1 percent a year to 18.5 percent. Ten-year returns ranged from 2.8 percent annually to 15.9 percent; 20-year returns varied from 5.3 percent a year to 13.8 percent; and 30-year returns ranged from 6-percent annually to 11.8 percent.

While the lower end of these returns are not spectacular, they are far from poor. Consider: if you earned 5.3 percent a year for 20 years, your investment would grow 181 percent. If you could earn 6 percent annually for 30 years, your money would grow by 474 percent.

ScotiaMcLeod has been advising Canadians on their investments for over 75 years. During that time, we have provided sound financial advice through a number of major market corrections, such as the market crash of 1987. Our experience has taught us that the best way to handle downturns is to maintain a long-term approach to investing that is consistent with the level of risk our clients wish to take.

Why do market prices fluctuate?

Since stock prices have increased over time, it takes investors off-guard when the market suddenly drops or "corrects" itself. To complicate matters further, no one knows when the next decline will occur.

There are many reasons why the market can take a sudden downturn:

- Company profitability
- Rising inflation
- Rising interest rates
- Better returns in other investments, such as bonds
- Political issues affecting the country and its economy

* Professor Jeremy Siegal, *Stocks for the Long Run, 1994*

There is no magical way of knowing which of these factors, or which combination of factors, will bring about the next market downturn. The important thing to remember, however, is that downturns are a fact of life, and over the long-term, the stock market has recovered and continued to reach higher levels.

What is the reason for current market volatility?

Intensifying economic troubles in Asia and Russia, collapsing commodity prices, and record lows on the Canadian dollar have all been factors in the volatility of the market today. The economic fallout in Asia has had a negative effect on some corporate profits, particularly in commodities which has had a direct impact on Canada as a major producer of natural resources.

The Canadian dollar has been undermined by a widening balance of payments deficit, weak commodity markets, poor returns in domestic fixed income and equity markets and investor nervousness about Asia.

The falling dollar is also reflecting the fact that the Canadian economy has lost some of its momentum in the past few months – as evidenced by recent reports on employment, housing starts, manufacturing shipments, and international trade. As a result, the Canadian economy is losing favour with foreign investors who are moving their money to safe-haven U.S.-dollar denominated securities.

How long does a decline last?

Many corrections only last a few days before the market regains lost ground. For example, on January 9, 1998, the TSE declined by 222.20 points or 2.8% in one day. Six days later, the TSE had recouped that loss. On June 15, 1998, the TSE experienced a 207.01 point drop, or 2.3%. Seven days later it was back to its original level.

The best advice is to stay the course and work with your Investment Executive, continuing your investment program and searching out good investment opportunities.

How can you protect yourself from a market crash?

Invest for the long term

When the stock market moves unexpectedly, most investors immediately think about shifting their investments into something else, like a money market fund. As stock movement since the 1987 crash has shown, the risk in stocks generally decreases the longer you hold on to your investments. You will also take advantage of the historical upward trend of the market.

Invest regularly

You can gain the upper hand in moving markets by sticking to a regimen of investing a set amount of money at regular intervals. Known as dollar-cost averaging, this strategy allows you to invest at different times and at different market prices. The stock price may fluctuate from month to month, but over the long term your average cost per share will be less than the average share price during the investment period. For example, if you invest $100 a month in a stock or mutual fund at an initial price of $20 a share. You'll start with an initial 5 shares. Then after one month, let's say the price goes to $25; to $10 a month later; to $30 the next month; to $15 the month after that and finally back $20, where it holds.

While it may appear on the surface that you have had no gain in six months since the stock is right back at the $20 level at which you first bought it, the reality is that because you invested $100 each month you have accumulated 34 shares at an average price of $17.65 Over the long term, your average cost per share will be less than the average share price during the investment period. As a result, you reduce your average cost per share and eliminate the worry and decision making required to time your investments.

Dollar-cost averaging does not guarantee a profit or protect against losses if you sell in a declining market, but it does offer a realistic and proven way to keep your investment plan on track.

Focus on quality

There are no guarantees when it comes to investing, but one of the best ways to protect your assets is to focus on quality investment vehicles at the risk level you are comfortable with.

Start by determining your tolerance for risk – how much you could afford to lose your investments in a downturn. Clearly, the closer you are to retirement or the more you depend on your investments for income to live, the less you can afford to risk.

For example, as a general rule, stocks of blue chip companies with a consistent history of growth and earnings are the safest in a downturn. In fact, shares in these seasoned, financially sound companies may be just the ones you should consider acquiring more of in a downturn.

At the other extreme of the risk scale are the newly minted companies which lack a solid track record. Generally, shares in these companies come with a greater risk of loss and will fare worse in any downturn.

Many stocks fall between these two extremes, however, and can offer you value.

What's important to always keep in mind is that the riskiest stocks are most often the ones which drop the farthest in a downturn. Talk to your ScotiaMcLeod Investment Executive to plan your investment strategy accordingly.

Diversify your investments

The best way to reduce your exposure to risk is to diversify your portfolio by company, industry, country, and asset class. This is one of the reasons why many investors have a combination of equity and fixed income investments in their portfolio.

By diversifying your investments into different types of stock (by company, industry, and country) you spread out your exposure to risk. If one of the companies in your stock portfolio faces declining profits, chances are not all of the companies are facing the same situation. The same holds true for the industries and countries covered in your portfolio.

Your investment advisor can help you determine the asset allocation that fits in with your present financial situation, your risk tolerance level, and your long-term investment goals.

Investor Protection

While there is no protection or guarantee against market loss, there are several safeguards in place for Canadian investors.

The Canadian Investor Protection Fund (CIFP) protects investors against loss due to the financial failure of their investment firm. The firm must be a member of one of the self-regulatory organizations, such as The Toronto Stock Exchange, the Montreal Exchange, the Vancouver Stock Exchange, The Alberta Stock Exchange, and the Investment Dealers Association of Canada (IDA). ScotiaMcLeod is a member of the IDA and a founding member of the CIPF.

The Canadian Deposit Insurance Corporation insures Canadian currency deposits in over 150 approved financial institutions – such as banks – up to $60,000. It was created in 1967 to restore confidence in the financial system following the failure of a major finance company.

Working with ScotiaMcLeod

You can continue to depend on ScotiaMcLeod to give your sound investment advice in both good markets and bad. Together with the timely insights of our research experts, we can help you ensure your investment plan is still on target with your long-term goals. Our experience has taught us that the best way to handle market downturns is not to deviate from your established investment plan. Some good investment opportunities do appear in times of market turmoil, and we can assist you in identifying the opportunities that are best for you.

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