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The Unconscious Swashbuckler

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Ever noticed how bull markets can transform once self-admitted "conservative" investors into the most aggressive thrill seekers?

Growth assets globally have enjoyed an unprecedented run in recent years, a period which has increased the appetite for risk among many investors.

Here in Australia, the share market has posted gains of more than 20 per cent for each of the last three years to reach a succession of record highs and is well on the way to another solid performance in 2007.

The US share market, as measured by the S&P-500 finally climbed above its March 2000 record peak in the past month. London's FTSE-100 index also reached unprecedented levels recently, as have equity benchmarks in Hong Kong, Taiwan, Singapore, South Korea and Indonesia.

Elsewhere, risk premiums on US corporate bonds fell to record lows in early June, hedge fund assets have tripled in the past decade to \$US1.6 trillion, while acquisitions by private equity firms are at record levels.¹

Such is the appetite for risk globally that international policymakers are sounding a warning bell about complacency.

The International Monetary Fund says while favourable economic prospects continue to underpin growth assets, signs of weakening credit discipline are leaving investors vulnerable.

"Investors may not be giving sufficient weight to downside risks, leaving markets vulnerable to the possibility of a volatility shock being amplified by the increased linkages across financial products and markets," the IMF said in its recent annual report on global financial stability.²

Those warnings have been echoed in recent weeks by the heads of both the United States Federal Reserve and the European Central Bank, who cautioned that risk is being priced at historically low and unsustainable levels.³

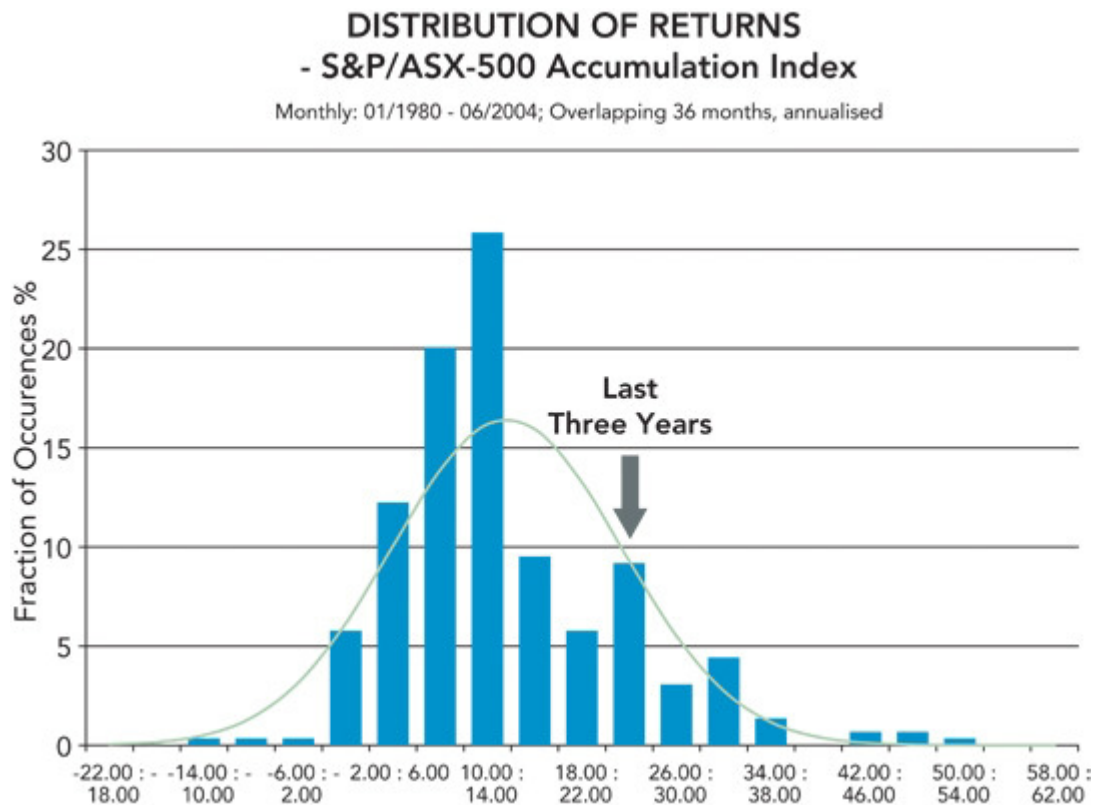
And now the Reserve Bank of Australia has added its voice to the chorus. Governor Glenn Stevens used a public speech⁴ in mid-June to warn businesses and investors against notions of the cycle being dead.

"The danger is that people become so confident that nothing can go wrong that they put in place financial structures, in particular higher leverage, and they make all sorts of other decisions which turn out to be very costly on the day when something does go wrong," Stevens told an audience in Brisbane. "And something will, sooner or later."

Can you see a pattern emerging here? The stewards of the global financial system are worried. They're not necessarily saying that a bust is around the corner. After all, no-one knows that. But they **are** saying that people are behaving in ways that could exacerbate any subsequent downturn.

In other words, investors need to ask themselves whether they are assuming risks that they would not otherwise take were markets not so favourable.

Take a look at the graphic below. Prepared on Dimensional's new Returns 2 program, it shows the dispersion of rolling three-year annualised returns for the broad Australian sharemarket over the past quarter century.



The horizontal axis maps various ranges of returns from negative to positive. The vertical axis charts the frequency of those returns.

What it tells you is that the frequency of the occurrence of the 22 per cent-plus annualised returns the Australian sharemarket has posted in the past three years is just 10 per cent.

The most frequent return range over a three-year period is between 10 and 14 per cent annualised, a result which has occurred almost a quarter of the time.

In other words, the market run we have seen since March, 2003 is unusual. Yet, it seems that many investors are unconsciously adjusting their long-term risk profile based on recent experience in financial markets.

This is not to imply that you should be seeking to time the market by shifting out of growth into defensive asset classes.

But you should periodically examine your asset allocation to ensure you are not using good times to take on more risk than you originally bargained for.

That's what's worrying global policymakers. Conscious conservatives are turning into unconscious swashbucklers.

¹Bloomberg data

²Global Financial Stability Report, International Monetary Fund, April 2007

³Trichet, Bernanke See Complacency in Markets', Bloomberg, June 5, 2007

⁴Glenn Stevens, 'Economic Conditions and Prospects', RBA, June 14, 2007