A year ago, I edited a note that countered the then common wisdom that investors should focus a large portion of their portfolios on the perceived opportunities in emerging market equities in 2011. Many investors believed (and continue to believe) that since emerging markets offered greater GDP growth than developed markets, that would result in attractive returns. We argued that the correlation between economic growth and equity performance was essentially zero, especially over short time horizons.

While economic growth was much stronger in emerging markets than in developed markets in 2011, emerging market equity market performance was awful. According to Bloomberg, China and India have generated year-on-year real GDP growth of 9.1% and 8.5%, respectively. However, the Shanghai Index fell 20% and its Bombay counterpart fell 24% in local currency.

The US, by contrast, generated modest GDP growth last year, but its equity market – with a total return of +2% – was among the strongest in the world over the calendar year of 2011.

We bring this up now to illustrate the critical need to focus on long-term investment truths when building portfolios, rather than on the noise of ‘experts’ making forecasts about what will happen in terms of economics and the investment implications. Even if the ‘experts’ are right about the economics, the ties to short-term investment results are tenuous at best. What’s more, exhibiting patience and ‘doing nothing’ can often be the right strategy – especially in volatility markets.

The dilemma is that most investors want to believe that answers are available about the future and market performance despite all evidence to the contrary. One of the most absurd – but consistently repeated in 2011 – comments on the equity markets was ‘investors are currently avoiding (or selling) equities because the outlook is uncertain.’ Uncertainty – and its cousin volatility – is a natural and unavoidable part of the investment landscape; low probability does not mean zero possibility.
Acting on the advice of those who believe they can ‘see around the corner’ can be hazardous to your portfolio’s health, whether the crystal ball gazers say: “now is the time for mid-cap German stocks”, or “it’s a risk-on, risk-off market and now is the time for ….”, or “inflation will come back with a vengeance, making US Treasuries high risk.” We also know that following the lead of high profile portfolio managers can also lead to dismal results.

Look at some events of 2011 which caught many forecasters and investors by surprise.

- ‘The Arab Spring’, with the downfall of leaders in Tunisia, Egypt, and Libya.
- The euro zone turmoil which led to significant global market stress.
- Questions around a potential dismantling of the euro.
- A potential slowing in the growth of China’s economy offset concerns of inflation risk.
- Commodities – including gold – declined and lost favour as both diversifiers and ‘stores of value.’
- The US government lost its AAA credit rating – but, contrary to expectations, prices on Treasury issues rose in the aftermath.
- Investors questioned whether there is a ‘risk-free’ rate of return or a risk-free investment.
- Investors were willing (or forced perhaps) to accept a negative absolute yield for Swiss debt.
- Long A number of noted portfolio managers’ clients paid the price for bets that Treasury yields would soar.
- An expected inflation surge – based on the amount of easing by central banks – failed to materialise.
- The presumptive economic recovery in developed markets weakened and the mood moved to talk of a ‘double-dip’.
- Factors reportedly responsible for the slowing of growth included: the continued looming threat of the global financial crisis on bank balance sheets; turmoil in Europe; fiscal constraints caused by sovereign debt levels; and weak overall demand that limited job growth globally.
- The decline of the US dollar as the reserve currency didn’t materialise, as both the euro and sterling weakened.

Other noteworthy developments in 2011

- Bank liquidity – especially in Europe – became an issue again, largely as a result of exposure to peripheral sovereign debt.
- Banks worked to meet more stringent capital guidelines resulting in smaller balance sheets with less lending and smaller trading books.
- An intensification of the normal tension between the French and UK governments. Seeing government leaders pointing fingers at one another stating that ‘the other’ had the worse fiscal / budgetary position was bizarre.
- Active managers of all types, including bond, equity, and ‘absolute return’ – struggled versus conventional, broadly diversified market benchmarks.
So, what’s next? While the shrewd answer may be ‘who knows?’ it may be worthwhile to summarise current conventional wisdom.

- Europe will muddle through. It will not be pretty or smooth, but all sides have too much to lose to risk the unknown results from a collapse of the euro.

- While ‘conventional wisdom’ doesn’t necessarily expect the collapse of the euro, many theories abound regarding what might happen if it does. However, this is new territory and no one knows what the direct and knock-on effects of a break up could be.

- The two biggest near-term concerns are the potential lack of global growth – the only real cure for repaying excess debt – and market liquidity. While a number of forecasters note that the US appears to show economic strength, there are concerns for other regions.

- Global growth will remain a concern longer term, but again, is the only real cure for repaying excess debt.

- Inflation will not be an issue for investors – near term.

- Equity valuations appear reasonable relative to history.

- Yields on ‘quality sovereign debt’ are low due to the liquidity premium they provide. Of course, it’s not clear when investors might decide the premium is too high.

- Institutional investors continue to view alternative strategies positively, despite evidence to the contrary and the difficulty of finding capable managers.

- In this presidential election year, Washington will remain in a state of paralysis regarding long-term solutions to budget issues.

- Serious geopolitical wildcards include: North Korea, Iran, and Syria.

A crucial lesson from 2011 is that even the most comprehensive list of conventional wisdom forecasts for 2012 will miss key issues. Moreover, even if the forecast of macro issues is on target, markets may respond differently than one might expect, based on either a flawed assumption (e.g. that relative annual GDP growth will determine relative equity market performance) or assuming ‘all else being equal ….’ (e.g. bonds with lowered credit ratings will have prices fall, not rise).

What should investors do? Vanguard believes that the best practice (in 2012 just as always) is to focus on long-term objectives and let long-term definitions of investment success (e.g. meeting a retirement goal over a 20-year horizon) and market history (e.g. the equity risk premium will exist but you need to accept the inherent volatility) drive your decisions. Daily assertions about ‘risk on, risk off’ can be entertaining, but they are a distraction that our experience shows rarely helps to build wealth over the long term.

Successful investors understand the need for patience and accept that the only certainty in investing is uncertainty. Simply stated, investors should not feel compelled to ‘just do something’; in most cases, the better advice is to ‘sit there’. Warren Buffett expressed this sentiment in defining the ‘Fourth Law of Motion: “For investors as a whole, returns decrease as motion increases”.”
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