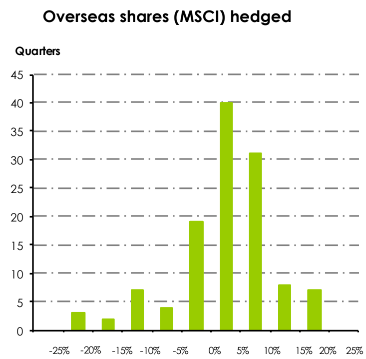
Understanding negative returns from shares

A general discussion

May 2015

We understand that when we invest in shares the value will go up and down, and will sometimes be negative. The question is how often should we expect a negative return over a quarter? What about over 1 year or 2 years? To illustrate, let's look at overseas shares without currency risks (i.e. overseas shares in local currency terms). The equivalent numbers for unhedged overseas shares in NZ$ and NZ shares, are on the back page.

Quarterly returns



Source: MSCI hedged index

Looking back

If we look at the 120 quarters in the last 30 years to 1 January 2014, we see a pattern of quarterly returns that range from -24% to +19% around an average of 2.5%. Of the 120 quarters, 35 were negative - about 29%.

The negative quarters averaged -7.4%. Most fell in the range 0% to -10%. However, when a quarterly return of -10% or more occurs, we should not be surprised. It will happen, but not often (about 10% of the time).

This highlights that negative returns occur frequently over the short-term. They are part of the investment outcomes for an investor, who wants a return better than that available from cash over the long-term. But if it is a negative over one quarter, what about the next quarter?

What about negative quarters in a row?

The next table allocates the 35 negative quarters to periods where the negative return lasted just a single quarter (16 times), two quarters (4 times), four quarters (once), and 7 quarters (once).

Number of consecutive negative quarters	Number of occurrences
1	16
2	4
3	0
4	1
5 or more	1

So, when a negative quarter occurred, there was a 54% chance that it was the first of several consecutive negative quarters and a 46% chance that it was an isolated incident. Very rarely have we seen more than two consecutive negative quarters but it does happen.

Also relevant are positive quarters. The table at the side plots the number of consecutive positive quarters within the same time period. Remember, the quarters with a positive return far outweighed the number of quarters with a negative return.

Number of consecutive positive quarters	Number
1	3
2	7
3	2
4	3
5 or more	8

What should I do about negative returns?

Negative returns over the short-term are unavoidable, unless you don't buy assets that go up and down in value. Given that they happen, it is important to put in place strategies to manage the outcome when they do occur. For many the answer will simply be to be patient and wait for the inevitable recovery. For others, it will be to maintain cash and bonds to provide cash to meet expenditure while they wait for the recovery.

A key investment principle is not to invest in shares, money that you intend to spend over the short to medium term (e.g. the next 10 to 12 years). If a negative return happens, you can wait for the markets to recover and not be forced to sell the shares when their values are down. This is one reason why an investor, near retirement, should have a mix of cash for immediate expenditure, bonds for medium term expenditure and shares for longer term expenditure.

A second key principle is to have appropriate diversification. It is often best not to have only overseas shares, or only NZ shares. This is because the two markets don't always go down together. Over the last 30 years, the number of quarters where the returns of the two markets were both positive (57 quarters), or both negative (14), or one was positive and the other negative (49). Therefore, unless you can work out in advance when one country will do better than another, it is better to hold a combination of the shares of different countries. A combination provides a better outcome, from a risk point of view, than holding the shares from a single country - this is the principle of diversification.

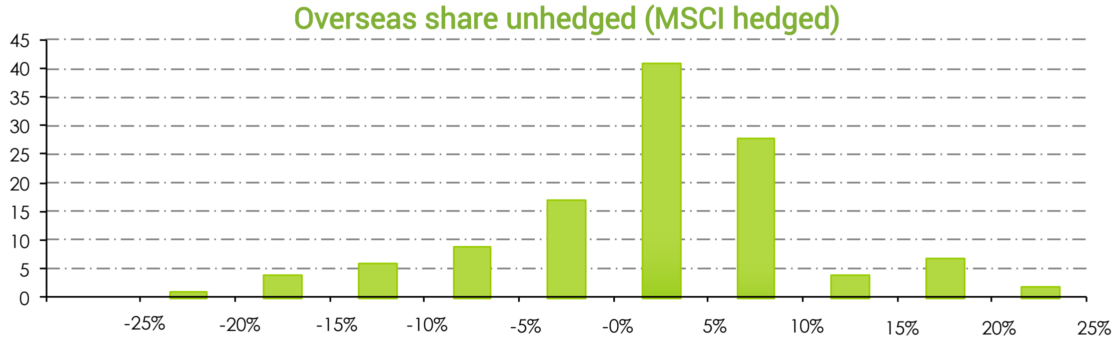
Overseas market	NZ market	
	Negative	Positive
Positive	26	57
Negative	14	23

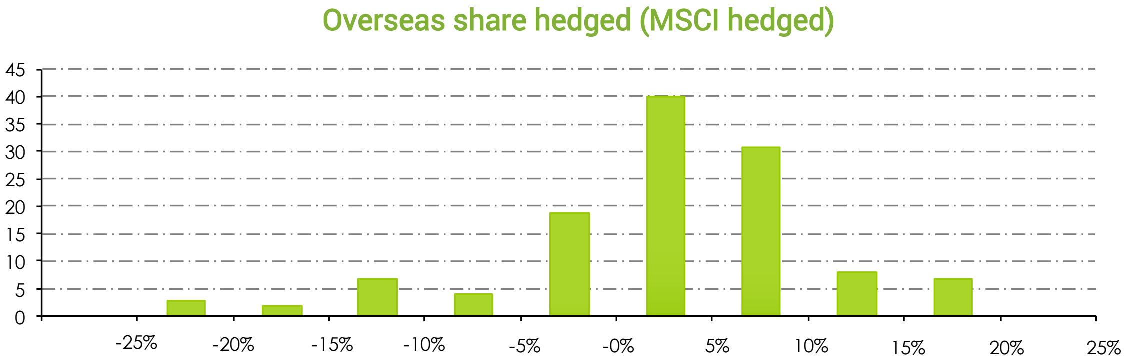
Looking forward

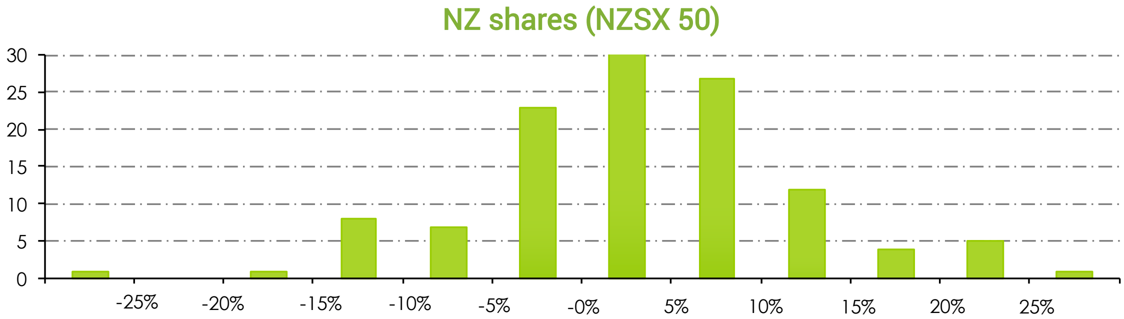
The above analysis is based on the past - what about the future? We do not know what the future will hold. However, we see few reasons why positive and negative returns will not occur with the same sort of frequency in the future, as they have in the past.

The statistics for unhedged and hedged overseas shares and NZ shares (1984 to 2013) are:

Frequency of returns over a quarter - each bar shows the number of times a return range occurred in a quarter







Number of consecutive negative quarters

MSCI unhedged		MSCI hedged		NZSX50	
No. of consecutive negative qtrs.	No of occurrences	No. of consecutive negative qtrs.	No of occurrences	No. of consecutive negative qtrs.	No of occurrences
1	18	1	16	1	15
2	4	2	4	2	8
3	2	3	0	3	1
4	0	4	1	4	0
5 or more	1	5 or more	1	5 or more	1

Number of consecutive positive quarters

MSCI unhedged		MSCI hedged		NZSX50	
No. of consecutive positive qtrs.	No of occurrences	No. of consecutive positive qtrs.	No of occurrences	No. of consecutive positive qtrs.	No of occurrences
1	8	1	3	1	9
2	6	2	7	2	5
3	0	3	2	3	3
4	4	4	3	4	3
5 or more	8	5 or more	8	5 or more	6