Dimensional

OUTSIDE THE FLAGS

Jim Parker,
Vice President
DFA Australia Limited

JULY 2013

Second Guessing

Markets recently have had a rocky time as investors in aggregate reassess prospects for monetary policy stimulus in the United States. Is this something to worry about?

The world's most closely watched central bank unsettled financial markets by flagging it may start later this year to scale back its bond purchases.

Under this program of so-called "quantitative easing", the Fed buys $85 billion a month in bonds as a way of keeping long-term borrowing costs down and helping to generate a self-sustaining economic recovery.

What spooked the markets was a comment by Fed chairman Ben Bernanke on May 22 that the central bank in its coming meetings may start to scale back those purchases.

The mere prospect of the monetary tap being turned down caused a reassessment of risk, leading to a retreat in developed and emerging economy equity markets, a broad-based rise in bond yields and a decline in some commodity markets and related currencies like the Australian dollar.

Gold, in particular, was hit hard by the Fed signals, the spot bullion price falling 23% over the second quarter on the view that rising bond yields and a strengthening US dollar would hurt its appeal as a perceived safe haven.

For the long-term investor, there are few ways of looking at these developments.

First, we are seeing a classic example of how markets efficiently price in new information. Prior to Bernanke's remarks, markets might have been positioned to expect a different message than what he delivered. So they adjusted accordingly.

Second, the reason the issue of the policy medicine being wound back has been raised is that the patient is showing signs of recovery. In other words, policymakers are seeing sufficient signs of growth to publicly countenance "taking away the punch bowl".

This is not to make any prediction about the course of the US or the global economy. It just tells you that policymakers and investors are reassessing the situation.

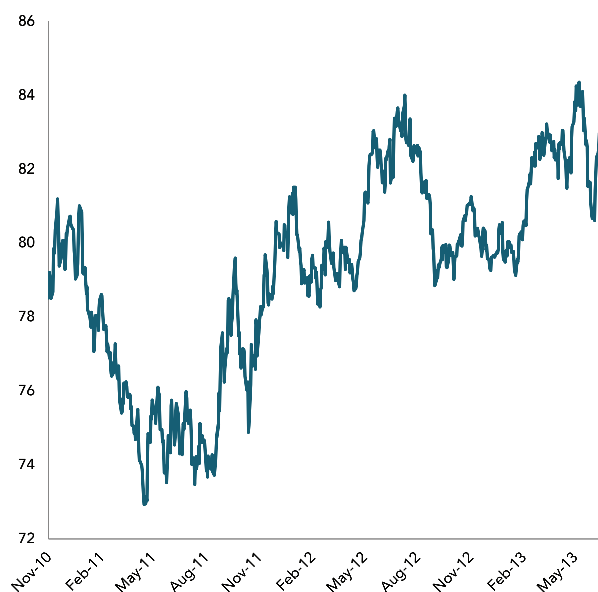
Third, for all the people quitting positions in risky assets like shares or corporate bonds, there are others who see long-term value in those assets at the lower prices. The idea that there are more sellers than buyers is just silly.

Fourth, the rise in bond yields is a signal that the market in aggregate thinks interest rates will soon begin to rise. That is what the market has already priced in. What happens next we don't know.

Keep in mind that when the Federal Reserve began its second round of quantitative easing in late 2010, there were dire warnings in an open letter to the central bank from a group of 23 economists about "currency debasement and inflation".

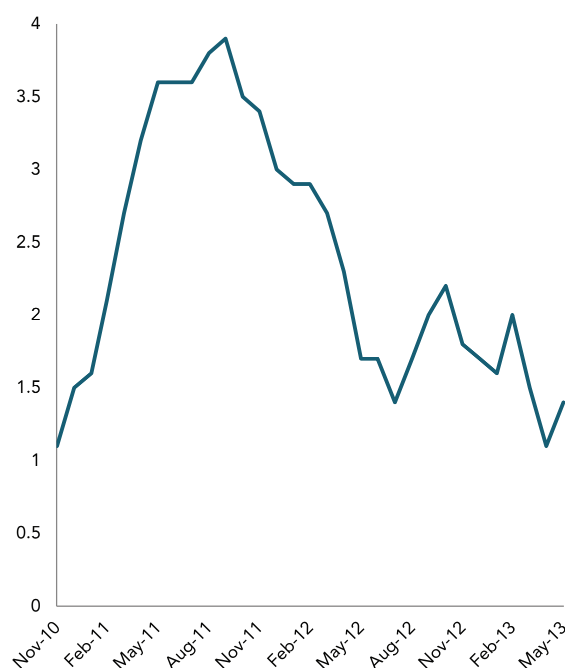
Yet, US inflation is now broadly where it was and the US dollar higher than when those warnings were issued (see charts below), suggesting basing an investment strategy around supposedly expert forecasts is not always a good idea.

US DOLLAR INDEX



Source: Bloomberg

US CPI YEAR-ON-YEAR (%)



Source: US Bureau of Labor Statistics

So it would pay to exercise scepticism with respect to predictions on the likely path of bond yields, interest rates and currencies in the wake of the Fed's latest signalling. Just because something sounds logical doesn't mean it's going to happen.

Fifth, a rise in bond yields equates to a fall in bond prices. Just as in equities, a fall in prices equates to a higher expected return. So selling bonds *after* prices have fallen echoes the habit some share market investors have for buying high and selling low.

Finally, keep in mind the volatility is usually most unnerving to those who pay the most attention to the daily noise. Those who take a longer-term, distanced perspective can see these events as just part of the process of markets doing their work.

1. 'Predictions on Fed Strategy that Did Not Come to Pass', Floyd Norris, New York Times, June 28, 2013

After all, the individual investor is unlikely to have any particular insights on the course of global monetary policy or bond yields or emerging markets that have not already been considered by the market in aggregate and built into prices.

What individuals can do, with the assistance of a professional advisor, is to manage their emotions and to remain focused on their long-term agreed goals.

Otherwise, the risk is you react to something that others have already countenanced, priced into expectations and moved on from as further information emerges.

Inevitably, second guessing markets means second guessing yourself.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

For more articles, visit Dimensional's client site at my.dimensional.com/insight/outside_the_flags

This material may refer to Dimensional Australian Resident Trusts offered by DFA Australia Limited. These Trusts are only available to persons in Australia and New Zealand in accordance with a Product Disclosure Statement (PDS) for the Trusts. The PDS is available from DFA Australia Limited as the issuer of the PDS, (ABN 46 065 937 671, Australian financial services license no. 238093) or by download from www.dimensional.com.au. Investors should consider the current PDS in deciding whether to invest in the Trusts, or to continue to hold their investments in the Trusts. Nothing in this material is an offer of solicitation to invest in the Trusts or any other financial products or securities. All figures in this material are in Australian dollars unless otherwise stated.

Dimensional Fund Advisors LP ("Dimensional") is an investment advisor registered with the Securities and Exchange Commission.

All expressions of opinion reflect the author's judgment at the date of publication and are subject to change without notice in reaction to shifting market conditions. This material is provided for informational purposes, and it is not to be construed as general financial product advice nor an offer, solicitation, recommendation or endorsement of any particular security, products, or services.

©2013 Dimensional Fund Advisors LP. All rights reserved. Unauthorised copying, reproducing, duplicating, or transmitting of this material is prohibited.

Dimensional

www.dimensional.com

34395_072013