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There are over 160 tables and charts within the Compendium of Investment. Sarasin & Partners LLP have endeavoured to ensure all are accurate and up-to-date: any errors or omissions are the fault of the authors and not those who have kindly supplied much of the underlying data.

THE INTANGIBLE ELEMENT OF INVESTMENT MANAGEMENT

Risk, timing and psychology; factors that are likely to influence investors' (and their investment managers') actions and thinking.

THE MEANING OF RISK

Risk is a little word for a very big subject. The risk of an investment is typically described by both the probability and the potential amount of loss, however, investors face a multitude of risks, all of which can take different forms. Over the course of this chapter we will cover a number of risks, focusing more closely on investment risk.

COUNTERPARTY RISK

Counterparty risk is the risk of failure on the part of the bank, stockbroker or investment manager who conducts transactions for the investor and may also hold the investor's securities and cash balances.

There are several levels of investor protection in place. For example, custodians hold clients' assets to the clients' order rather than their own, so the assets are ring-fenced and the clients are protected in the event of the custodian failing. Auditors and regulators exercise close supervision over the whole financial services sector and there are compensation schemes in place.

However, disasters can still occur and the best protection for the investor is to limit dealings to firms of the highest quality, standing and credit-worthiness. Most financial institutions now devote more effort than ever before to assess the strength of their counterparties and keep their arrangements under regular review.

LIQUIDITY RISK

In essence, liquidity reflects the ability of an investor to realise the value of an asset at a given point in time. More specifically, liquidity risk describes the danger that an investment can not be sold quickly enough in the market without a detrimental impact on its price. Typically, this would manifest itself in falling prices as demand falls, the gating or temporary closure of funds or, in extreme cases, the failure of businesses.

Liquidity events are often a function of the immediacy of the order, the depth of the market, i.e. the number of active participants, and the volume or quantity of the asset that is being exchanged. Negative outcomes tend to occur in assets that are thinly traded at very low volumes and at times when activity or demand is low. Investor sentiment can also play a significant role in distorting supply and demand dynamics, leading to an increase in liquidity risk.

The danger for investors occurs when there is a mismatch between the liquidity of the underlying asset and the liquidity of the vehicle in which it is held and accessed. A number of high profile liquidity crises have occurred when particularly illiquid securities are held in daily dealing fund structures and a change of sentiment results in the fund manager being forced to sell assets for which there is no liquid market. Limits on the proportion of illiquid assets able to be held within certain regulated funds can compound the pressure on a fund manager, who is then forced to sell assets at fire sale prices.

INVESTMENT RISK

Investment risk is the risk that is inherent in the investments themselves. In one sense, investment risk means the danger of a particular asset within an investor's portfolio failing and it becoming worthless. However, this is a narrow definition of risk since it deals only with the extreme forms and, if the investor wishes, risk of this nature can be reduced through diversification to the point where any one single asset failing is inconsequential.

If one holds just six equity investments of equal value, the failure of one of them requires the other five to each rise by 20% to restore the value of the portfolio. If one holds fifty investments of equal value, the other forty-nine need only rise by 2% each to restore the original position.

Furthermore, it is not a definition of risk that can be applied to all forms of investment equally. For example, there is little risk of the UK Government failing to honour its obligations in the gilt market. However, there will be a risk that the price of a gilt fluctuates at a time when an investor needs to sell it prior to maturity.

Against this backdrop, one measure of investment risk is the volatility of returns from an investment over time, as measured by standard deviation.

Standard deviation is an arithmetical measure of variability. The wider and more variable the range of the returns that an investment displays, the greater its inherent risk as evidenced by a higher standard deviation. Similarly, the lower the standard deviation, the lower the inherent risk.

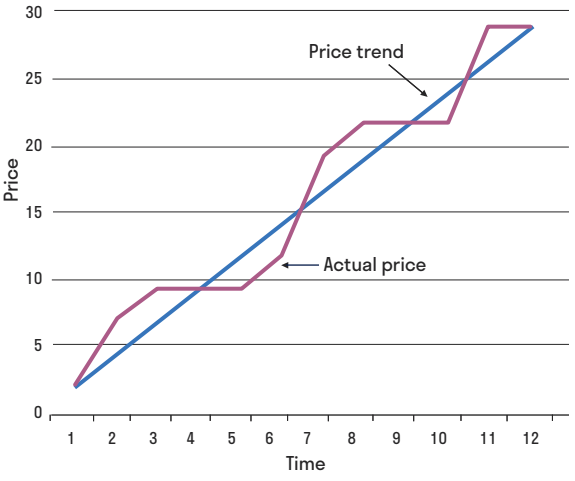
By way of illustration, Table 22.1 shows the price behaviour of a highly volatile investment 'A' and Table 22.2 shows the price behaviour of a low-volatility investment 'B'.

It is only necessary to glance at these diagrams for a moment to realise which of these two securities the investor is more likely to misjudge when making buying and selling decisions. Investment 'A' clearly provides more opportunity for error since its price moves more frequently and by a greater amount than that of investment 'B'. Standard deviation is simply an expression of the frequency and amplitude of these oscillations. In other words, standard deviation is no more than a mathematical expression of a common sense observation.

22.1 Investment 'A'

Source: Sarasin & Partners LLP

22.2 Investment 'B'



Source: Sarasin & Partners LLP

Common sense suggests that shares are more volatile and therefore riskier than gilts, whilst both are riskier than cash on deposit. However, using standard deviation, it becomes possible to quantify this difference in risk and relate it in a scientific way to the returns that different forms of investment offer.

How does volatility create risk? In a falling market, it creates the risk of having to sell at a bad time, it creates the worry which keeps some investors awake at night, it creates the fear of another crash every time markets are weak and it creates the temptation to sell out in despair at the bottom. In rising markets, it creates the temptation to sell prematurely. It can also lead to the temptation to borrow in order to invest more. In short, volatility distorts investors' judgment by magnifying the emotions of fear and greed. Ultimately, short-term price fluctuations are only a risk should an investor need to sell at an inopportune time, thereby permanently impairing the value of their capital. This aspect of investment is discussed in more detail on page 170 in the chapter dealing with The Psychology of Investment.

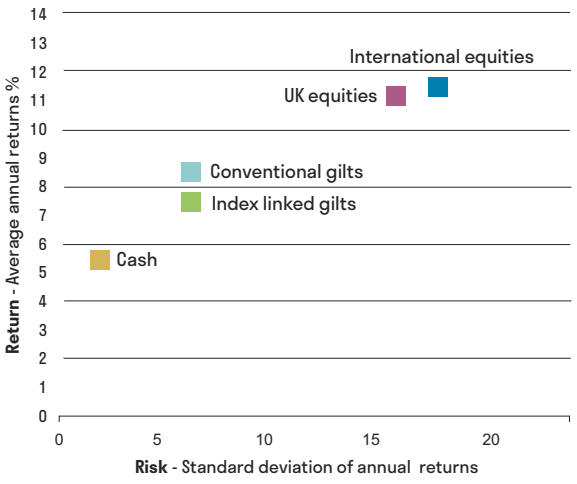
Market participants must be paid for assuming these risks or else the whole system of financing businesses would break down. Therefore, equities must provide a long-term return that is significantly higher than the risk-free return available by simply leaving money in the bank. Similarly, investors in gilts expect to earn a higher return than cash on deposit since the Government will not be repaying the money for many years and there is a risk that what is an attractive interest rate today may not prove as attractive later on.

Table 22.3 plots the risk and return characteristics of cash on deposit, UK equities, conventional gilts, index-linked gilts and overseas equities since 1982 - the longest period during which all these instruments have been available to investors. Overseas investment was subject to exchange controls until 1979 and index-linked gilts were only made generally available to investors in 1982.

As suggested earlier and as common sense indicates, shares are more volatile and therefore riskier than gilts, whilst both are riskier than cash on deposit. Overseas equity investment is the most volatile of all since there is currency risk as well as underlying stock market risk.

It can also be seen, in recognition of this greater element of risk, that conventional gilts have provided higher returns than cash on deposit and UK equities have provided higher returns than both.

22.3 Unit Trust / OEIC volatility (%)



Source: Sarasin & Partners LLP

Interestingly, index-linked gilts have provided the lowest return despite involving significantly more risk than cash on deposit. This is partly because cash on deposit earned an unusually high real interest rate over much of this period.

The practical significance of this is that, in the same way that standard deviation can be used to assess the risk and return characteristics of individual investments or asset categories, it can also be used to assess the performance of an investment portfolio to see if the return adequately compensates for the degree of risk taken. The more data points used, the better the quality of the message that will emerge, but five years of quarterly data or three years of monthly data will generally start to provide a fairly clear signal.

By way of illustration, if two portfolios have each given a return of 20% per annum then, on the face of it, both returns are equally satisfactory. However, if portfolio 'A' had at first doubled in value and then fallen back sharply to give the overall 20% return, whereas portfolio 'B' had compounded gradually at a consistent 4% to 5% a quarter to reach the 20% return, the latter would represent the better quality return since it would have been achieved with less risk, as measured by volatility.

As an illustration of the way in which this methodology can be applied to real portfolios, league tables of unit and investment trust performances now commonly include a measure of volatility alongside the raw performance data.

22.4 Unit Trust / OEIC volatility (%)

Average fund	3-year volatility
UK Money Market	0.1
UK Bond	3.6
UK Equity Income	9.9
UK Equity	9.8
Japanese Equity	10.5
European Equity	10.5
North American Equity	11.8
Asia Pacific (ex-Japan) Equity	12.9
Emerging Markets Equity	11.7

Source: Morningstar

22.5 Asset mixes and headline statistics (%)

	Model A	Model B	Model C
UK bonds	**85**	**50**	**15**
UK equity	**15**	**50**	**85**
Historical return	6.0	7.6	8.9
Yield	1.6	2.6	3.7
Standard deviation	10.9	13.8	18.7
Value at risk	12.0	15.1	21.9

Source: Sarasin & Partners LLP

Table 22.4 shows the way in which the volatility of unit trust performance varies in light of the nature of their underlying investments.

Here again, the measure of volatility bears out common sense judgement - money market trusts are the least volatile, whilst emerging markets and Far East funds tend to be the most volatile, with everything else on a rising level of volatility in between.

By using historic returns from a variety of asset classes, and mixing them together in different proportions, one can show the key risk characteristics of different model portfolios. Table 22.5 looks at three possible asset mixes and notes the headline statistics that would be associated with them.

It can be seen that as the equity content increases, the historical return increases from 6.0% per annum to 8.9% per annum. There is also a corresponding increase in the risk. This is shown by the increase in the standard deviation and Value at Risk (VaR) statistics. In this calculation the VaR statistics are calculated to show that, in normal market conditions, an investor should expect to lose at least this amount 1 in every 20 years, or 5% of the time. In reality the maximum loss that an investor could have experienced is far greater.

The result of modelling like this can go a long way to help investors decide what asset mix suits their particular investment objectives. Taken to the extreme, it is possible to create an efficient risk/return frontier made up of a series of portfolios that weight a very wide variety of assets in different proportions. Technically, all that investors then need to do is choose the portfolio whose risk/return characteristics most suit their underlying investment objective.

However, a word of warning! Tables and charts like this tend to over-simplify a very complicated subject. Measuring the historic investment returns from a range of asset classes and predicting future returns in the light of economic and market forces is one thing. Factoring risk into models is another and the compound effect of combining so much data, much of which calls for a high degree of subjective judgement, means that the output is rarely free from debate.

One issue most experienced investors realise is that risk is very rarely removed altogether - it is simply transferred somewhere else. The trick is to know what risks you are taking and where and whom they ultimately rest with.

One way of drawing out risk and the misinterpretation of it is illustrated by Tables 22.6 to 22.8. Table 22.6 shows a commonly used analysis of the risk and return impact of mixing two asset classes together, in this case UK government bonds and UK equities. It can be seen that as the proportion of equities increases, so does the risk. This is used to show how much riskier equities are than bonds.

However, this well-travelled diagram is actually misleading unless one is contemplating a 12 month investment. Investors who have a timeframe stretching beyond a single year should consider the volatility of the assets over periods longer than just a 12 month timeframe.

Longer-term investors should also consider inflation. Table 22.7 shows the 1 year data but this time in 'real' terms. It can be seen that the overall level of returns drops. Interestingly, while the volatility of real equity returns reduces, the volatility of bond returns increases as inflation can have a more negative impact on fixed interest investments.

Table 22.8 re-draws the line after taking account of different periods of investment. As the holding period increases, the volatility of real equity returns reduces much more quickly than bonds. This would suggest that, for the longer term investor, equities produce better real returns than gilts with a lower degree of risk. This is perhaps not that surprising when one considers the greater real returns generated by equities since 1900 as evidenced in Chapter 1.

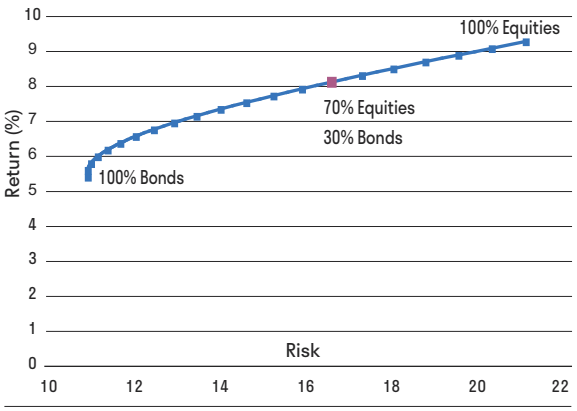
This chapter has set out to address risk by concentrating on volatility since this is the most commonly used definition. However, it is also one of the less sophisticated measures and beyond standard deviation there are a number of more complicated risk measurement tools.

For example, the concept of 'beta' relates to the sensitivity of the price movements of individual securities or portfolios to movements in the market as a whole. The concept of 'tracking error' measures the volatility of a portfolio's return relative to an index or benchmark. The concept of 'Sharpe Ratio' recognises that risk is a good thing if rewarded properly, by measuring the excess return above the risk free rate (usually cash) from a security relative to its volatility. The concept of 'information ratio' does this for a portfolio in relation to the benchmark return.

'Value at Risk' measures the maximum likely loss that any given portfolio is likely to incur in normal market conditions. This can be a particularly useful concept for the charity trustee looking to gain a feel for the maximum capital loss their portfolio might suffer. Although, we must acknowledge that normal market conditions do not prevail all the time so this measure should only be used as a guide.

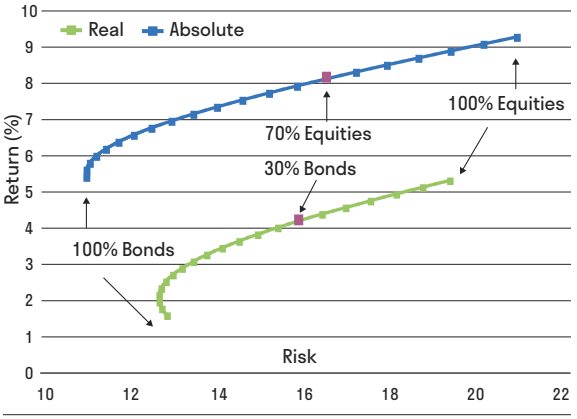
Ultimately, risk is a perception in each investor's mind that results from analysis of the probability and amount of potential loss from an investment. Investor's tolerance of this risk will vary greatly depending on their own individual circumstances.

22.6 Efficient frontiers: mixed bond and equity portfolios
1 year volatility absolute



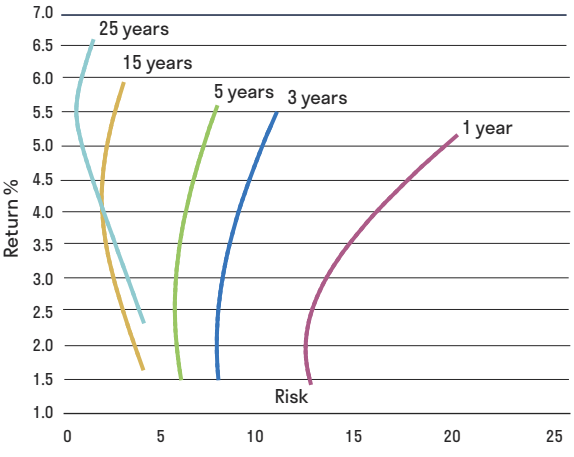
Source: Sarasin & Partners LLP

22.7 Efficient frontiers: mixed bond and equity portfolios taking account of inflation
1 year volatility real



Source: Sarasin & Partners LLP

22.8 Longer-term efficient frontier studies real returns
Multiple year volatility



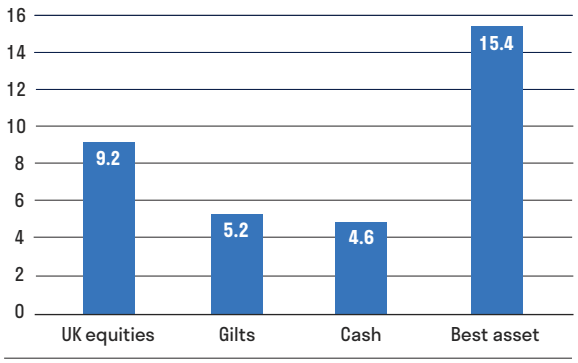
Source: Sarasin & Partners LLP

TIMING

It is sometimes said that investment is all about timing. It would be true, up to a point, if investors could count on getting their timing right most of the time but, since they cannot, investment policy cannot be predicated on it.

There is clearly scope for seeking to boost performance by exploiting the market cycle by buying low and selling high. To take an extreme case, Table 23.1 compares the annualised return from UK equities, gilts and cash since 1900 with the return which could have been earned had one successfully switched at the beginning of each year into whichever of these asset categories went on to perform best in the following twelve months.

23.1 Long-term UK investment returns 1900 - 2019 (%)



Source: Barclays Equity Gilt Study / FTSE International Ltd / Sarasin & Partners LLP

While this is an unrealistic example, the scale of the difference in the return from choosing the best investment category each year shows why investment managers devote so much time and effort to tactical asset allocation.

23.2 A recent history of UK bull markets

	Months	Change %
9th November 1966 - 31st January 1969	27	106
27th May 1970 - 1st May 1972	23	100
13th December 1974 - 30th January 1976	13	179
27th October 1976 - 4th May 1979	30	145
15th November 1979 - 17th August 1981	22	55
28th September 1981 - 16th July 1987	69	365
10th November 1987 - 3rd January 1990	26	56
24th September 1990 - 11th May 1992	19	38
25th August 1992 - 2nd February 1994	17	70
24th June 1994 - 20th July 1998	49	99
5th October 1998 - 4th September 2000	23	48
12 March 2003 - 12th October 2007	57	104
3rd March 2009 - 7th July 2011	28	93
4th October 2011 - 27th April 2015	42	50
11th February 2016 - 22nd May 2018	27	42
Average	**31**	**103**

Source: FTSE International Ltd / Sarasin & Partners LLP

23.3 A recent history of UK bear markets

	Months	Change %
31st January 1969 - 27th May 1970	16	-37
1st May 1972 - 13th December 1974	32	-73
30th January 1976 - 27th October 1976	9	-33
4th May 1979 - 15th November 1979	6	-23
17th August 1981 - 28th September 1981	1	-22
16th July 1987 - 10th November 1987	4	-37
3rd January 1990 - 24th September 1990	9	-22
11th May 1992 - 25th August 1992	3	-22
2nd February 1994 - 24th June 1994	5	-18
20th July 1998 - 5th October 1998	2	-25
September 2000 - 12th March 2003	30	-52
12th October 2007 - 3rd March 2009	17	-48
7th July 2011 - 4th October 2011	4	-18
27th April 2015 - 11th February 2016	10	-21
22nd May 2018 - 27th December 2018	7	-17
Average	**10**	**-31**

Source: FTSE International Ltd / Sarasin & Partners LLP

However, human emotion can drive investors to sell or purchase assets at precisely the wrong time in the cycle. Consequently, investment success is much more likely to come from establishing the right long-term asset mix, and adding some incremental return to performance through tactical asset allocation and successful stock picking. Investors should certainly aspire to good timing, since it has the potential to make an important contribution, but it cannot be placed at the heart of policy.

This is the essence of the traditional 'buy and hold' investment strategy that most long-term investors follow. It has been open to challenge, particularly during times of uncertainty, as it obviously does not work during bear markets. Some hedge fund strategies, which place much more emphasis on timing, aim to shield investors in market downturns. However, the successful long-term performance record of 'buy and hold' investing remains intact and there are powerful reasons for believing that it remains the most sensible mainstream approach to investment.

Against this background, investors who are either investing in the stock market for the first time or adding fresh funds to their portfolio have two main timing options open to them.

One is to stay in cash or near-cash in the hope that a major stock market setback will occur, providing the opportunity to switch into the market at a low level.

The other is to conduct a phased programme of investment designed to move the money into the stock market in several stages. By averaging the entry level, one hopes to pay a reasonable overall price for the shares bought. Some will have been bought at levels that prove high in the short term, others at price levels that will prove low. Overall, the average prices paid should prove satisfactory.

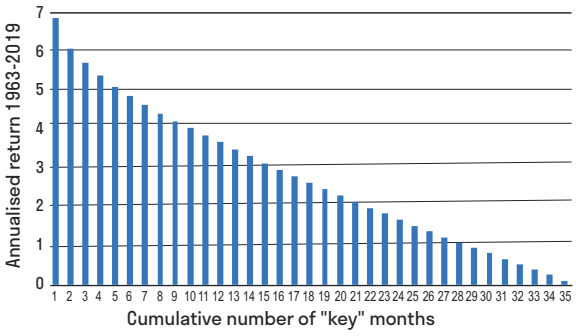
This second approach generally proves more successful. Indeed, the first approach risks the possibility of never getting into the market at all. It also risks entering the market belatedly when the outlook seems safer and having to pay higher prices with a resulting opportunity cost. There is never a 'safe' buying opportunity in the stock market - investors cannot expect to be paid a premium return for assuming investment risk without actually doing so!

A normal policy would be to invest part of the money straightaway in order to establish a base position, and then invest the balance in several stages over, perhaps, the following twelve months.

The important point is that, once the case for investing in the stock market has been accepted, one should get on and make a start. Otherwise, the strategic decision to invest risks being subordinated to highly fallible tactical timing decisions.

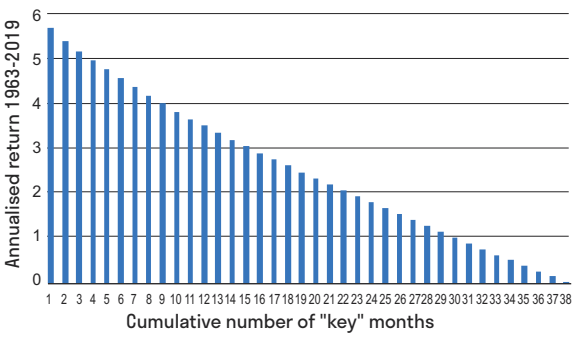
The potential penalties of being out of the market are illustrated in Tables 23.4 and 23.5. History shows that the really sharp rises in markets tend to be bunched into a comparatively small number of quite short time periods - the investor who has been out of the market at these key times has usually earned significantly below-average long-term investment returns.

23.4 The effect on long-term UK equity performance of being out of the market in the best individual months
(%)



Sources: FTSE International Ltd / Sarasin & Partners LLP

23.5 The effect on long-term US equity performance of being out of the market in the best individual months
(%)



Sources: Standard & Poor's Financial Services LLC / Sarasin & Partners LLP

The tables show the effect on investment returns in each of the major investment territories for investors who were out of the market in the best individual months of the periods shown. Thus, taking Table 23.4 which shows the UK experience, the compound return earned by the 'buy and hold' investor who had been in the market throughout the period 1963 to 2019, would have been 7% per annum. However, the total return over this period could have been generated by being invested in the market in just 35 of the 684 months in the period!

The investor who was out of the market in each of the 35 key months would have experienced a capital loss. Put another way, all the return was earned in 5% of the period. The study begins at the start of 1963 since this was the first full year that the FTSE All-Share Index was in existence. It deals with capital return only, ignoring income.

Table 23.5 shows the same data for the US market. The US data covers the same 1963 to 2019 period as the UK data in order to provide comparability.

It can be seen that the international message is the same as for the UK. The US equity investor would have lost money if out of the market in the 38 key months.

Of course, this argument can be turned on its head. How much better if the investor had only participated in the markets in these key months and kept the money on deposit the rest of the time!

Similarly, suppose the investor had avoided the worst months in each market over this period? In the UK, missing the 35 best months would have reduced the underlying return of 7% to 0% whereas being out of the market for the worst 35 months would have increased the underlying return to 16%. The picture is similar outside the UK.

However, investors cannot count on seeing these key months coming and getting into or out of the market just in time. Apart from the inherent implausibility of a strategy predicated on such precise timing, these key months have often followed periods of sharp market movements in the opposite direction.

For example, the investor who has sold out of the market successfully on the way down and is looking for the moment to buy back in, would invariably have to reinvest at a time when they are faced with an even more negative outlook than when they sold. It is unlikely that an investor wishing to feel safe in entering the market would have bought at those times.

In short, if one accepts the powerful weight of evidence that shares go up more often than not, the best way of dealing with the challenge of timing is to 'buy and hold' and not attempt to trade in and out of the market. Economies grow most of the time, so stock markets rise most of the time. They may move ahead of events sometimes but, even then, events will catch up in due course and validate market levels.

THE PSYCHOLOGY OF INVESTMENT

Rather like buying or selling a house, stock market investment can easily bring out the worst in people.

A rising market probes for greed in the investor's make-up. When it finds greed it plays on it, tempting the investor towards a higher risk strategy with the promise of higher returns. The higher the market goes, the greater the temptation investors face to increase their level of risk, abandoning the principles that have governed their investment policy in the past. Yet, the higher the market goes, the lower the incremental return is likely to become for the extra risk being assumed and the greater the chances of a subsequent setback.

A falling market probes for fear in the investor's make-up. When it finds fear it plays on it, tempting the investor towards a lower-risk strategy with the threat of further price falls. The lower the market goes, the greater the temptation investors face to reduce their level of risk, abandoning their fundamental belief in stock market investment. Yet, history shows that the lower the market goes, the greater the future returns.

The circle is complete when an investor is lured into buying at the top and terrorised into selling at the bottom.

The trap is obvious in principle but it rarely presents itself in the same way twice. It is invariably camouflaged with good reasons for the investor to believe that "it will be different this time round". One only has to think of the extraordinary boom and bust in technology shares at the turn of the millennium! This turned out to be a classic stock market bubble masquerading as a 'new paradigm'.

Whenever not making a particular point of probing for fear or greed, the market probes instead for vanity. At the level of asset allocation, the market invites the investor to interpret the trend of political events and anticipate the cycles of economic growth, currencies and inflation to choose between the major investment markets of the world. At the level of stock selection, it invites the investor to form a view of broad industrial trends around the world and assess the strengths and weaknesses of tens of thousands of companies at home and abroad.

In short, it plays to the vanity of sitting in judgement on others. Tom Wolfe satirised the Wall Street investment bankers of Bonfire of the Vanities as "masters of the universe" for good reason!

However, the market flatters to deceive. In investment, it is often quickly apparent if a judgement has been right or wrong. Even if the underlying judgement is correct, the timing may still be wrong. Share prices move by the moment and investment performance is calculated quarterly. Every thirteen weeks the outcomes of all these decisions are tested to a decimal place.

Having encouraged their vanity, the market is brutal in confronting investors with the fact that they are often wrong, tempting them into abandoning the application of principles in their investment policy. Once detached from fundamental beliefs about the right way to approach investment, investors fall back on pragmatic trading, setting themselves up to be doubly exposed to the distorting influences of greed and fear.

Greed, fear and vanity are elemental human weaknesses. How should investors with stock market investments proceed, knowing that both they and their investment managers are prey to these powerful forces?

Experience suggests that the starting point is to have realistic expectations about what can be achieved by stock market investment.

The next step is to appoint an investment manager whose methodology is persuasive and whose philosophy the investor can share in both good and bad times.

Finally, it is important to leave the manager to apply this methodology over a period of about five years without seeking to influence policy unless the investment objectives change. At the end of this period, the results should speak for themselves. Unfortunately, it is not as simple as this.

No single approach to investment is right all the time so there are bound to be periods of underperformance. Investment managers want to keep their clients when performance passes through a difficult period, so in weak moments there is inevitably a temptation to change course and adopt a different approach that seems more in keeping with the times. However, the disciplined application of clear principles, based on deeply held convictions, is the key to resisting the play of the markets on the emotions and breaking the distorting cycle of greed and fear. Therefore, investors need to take care in setting the tone of their relationship with their manager at such times if they are not to contribute to an amplification of the problem.

Provided their confidence in their manager's methodology is intact, the best contribution that investors can make during a period of underperformance is to buttress their manager's determination to persevere.

This means re-testing the arguments on which the methodology rests and probing the manager's investment process. If the manager can demonstrate reasonable grounds for thinking that the process remains sound and ought to produce satisfactory results again in due course, there need not be criticism.

On the other hand, there will be times when the performance problem has been caused precisely because the manager has fallen prey to fear, greed or vanity. A manager's methodology may have become more aggressive the further a bull market has risen or uncharacteristically cautious the further a bear market has fallen. A run of success in the past may have drawn a vanity to the surface that is now expressed in an insufficiently self-critical investment process resulting in the taking of bigger risks. Knowledgable investors will be watching for such signs as they probe the manager's investment process.

In short, the best way for investors to protect themselves against the potentially damaging emotions which stock market investment can unleash is to recognise the problem in the way in which they manage their relationship with their investment manager. If the relationship is a partnership, with the obligations but tolerance and goodwill that this implies on both sides, the manager should have the confidence to stick to his guns and resist the market's assault on his emotions.

PLANNING FOR BEAR MARKETS

The savage bear markets of 2000-2003 and 2007-2009 together with the current economic concerns are salutary reminders of the risks inherent in investment, some of which had lain dormant for many years. What are the lessons? What steps can a charity take to help it weather future bear markets when they occur?

As Table 23.3 on page 167 illustrates, there are two sorts of bear market. The most common is the short, sharp variety, while the other is the slow lingering type.

Bear markets are invariably rooted in a deterioration in economic conditions which is then magnified dramatically by investors revising downward the valuations that they are willing to apply to financial assets in the new environment. If UK company dividends were to fall by 5% in a recession then, other things being equal, their share prices would fall by 5% too. However if, in a climate of unease, investors decide to de-rate the resulting dividend stream from a 3% yield to 4%, the shares will fall by a further 25%, making a 29% fall in total.

In practice, bear markets invariably begin when least expected and for reasons hitherto unforeseen. They often follow a euphoric bull market in which many new investors have been sucked into the market in the belief that the risk of investing is much lower than it really is. They often begin with a period of drift before the real setback takes hold. They are usually well under way by the time most commentators are willing to accept that the earlier bull market is really over.

Above all, bear markets create a severe shock that is the characteristic that distinguishes them from a bull market setback. Once a bear market is an established fact, the world looks very different. In a bull market setback, investors look for buying opportunities.

In a bear market bounce, investors look for selling opportunities. In a bull market setback, investors are content to sit tight, confident that prices will be recovering again before long. In a bear market, they question whether the stock market is really an appropriate medium of investment at all. It is scarcely necessary to say that this sense of shock is not to be underestimated - bear markets shatter investor confidence in ways scarcely imaginable at the peak of a bull market. Greed is one thing - fear is quite another. The long-term evidence in favour of equity investment counts for a great deal less if you are a trustee who has just suffered a 25% fall in the value of your charity's equity portfolio, possibly in just a couple of weeks, and there seems little prospect of recovery in the foreseeable future.

All this is instantly recognisable from the experience of recent years and there is every chance that future bear markets will be equally savage. Additionally, despite the speed of recovery witnessed in 2009, investors must be wary of expecting that central banks will ride to the rescue after any future collapse in confidence and asset values.

Therefore, investors in the stock market must take great care to ensure that they can cope with the variety of bear market conditions that will inevitably occur from time to time.

A checklist of issues for a charity to consider should include the following points:

1. Are all the trustees aware that the value of their portfolio is certain to suffer a sharp setback from time to time?

2. What will others connected with the work of the charity think when this happens - especially those on the fund raising side and those with little or no experience of the stock market? Are all interested parties aware that investing part of a charity's funds into the stock market represents a calculated risk that inevitably exposes it to a loss on paper from time to time?

3. Are the trustees aware that their investment manager is unlikely to see a bear market coming and will not, therefore, be likely to take very much evasive action?

4. Is the charity in a position to leave its portfolio undisturbed for the duration of a bear market and sit it out, or is there a known requirement to raise cash to meet planned spending commitments before long? Trustees should think long and hard before leaving funds invested in the stock market if they know that those funds will be needed elsewhere before long. Otherwise, they risk being forced sellers at an inopportune time.

5. Is the charity's portfolio suitably diversified with a certain amount invested in more defensive assets such as British Government bonds, index-linked gilts, international bonds and cash that can all provide protection, ballast or a cushion at a time of falling share prices? In the late stages of a bull market it is easy for investors to drift into holding too much in equities simply because they have swollen as a proportion of the whole.

6. Is the equity portion of the charity's portfolio suitably diversified with at least forty to fifty different holdings? If so, the charity can enter a bear market with some confidence that even if one or two of its companies were to underperform dramatically or maybe even fail, the portfolio as a whole may not be unduly affected. If not, the theoretical long-term growth case for equity investment, based on the performance of broad indices, may be fatally undermined by the underperformance of a significant percentage of the equity portfolio.

7. Does the charity hold many investments that would be particularly badly affected in a bear market - companies with high borrowings, companies whose growth has depended heavily on share issues to finance acquisitions, financial companies whose prosperity is closely linked to stock market conditions and so on? Such investments can offer attractive returns but it would be unwise for a charity to invest disproportionately in companies of this nature.

8. Does your fund manager have the ability to use asset classes such as infrastructure, commodities and hedge funds which could provide uncorrelated returns, together with portfolio insurance? It may be that while your fund manager would find it hard to make a significant move into cash and gilts (a move that on most occasions is proved with hindsight to be inopportune and harmful to long-term performance) they might be more willing to take advantage of absolute return oriented asset classes and tactics in an attempt to limit downside while retaining the potential for some further capital appreciation.

If investors prepare themselves in these ways, the onset of a bear market need not be of too great a concern. A bear market is part of the ordinary stock market cycle. Although sometimes hard to believe whilst it is happening, it is a temporary phenomenon.

Investors must accept bear markets as the price to pay for enjoying the superior returns which equity investment will provide over the longer term. They typically act as corrective episodes after period of excessive investment returns.

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