fortytwo

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THE LONG AND WINDING ROAD

Never let the facts get in the way of a good story

By Alan Dick CFP

With the three year stock market collapse in the wake of September 11th, the first ten years of this century came to be known as a lost decade for investors. Last week marked the fifth anniversary of the start of the Credit Crunch; the effects of which are still rumbling on. More recently we have had the Eurozone crisis which shows no sign of ending in the foreseeable future. A recent completely sensationalist article in MoneyWeek Magazine claimed that the Chinese ecomomy is about to implode. Banks are apparently all totally corrupt and nearly bankrupt as are most governments. It sometimes seems like the torture never stops.
Now that we've got the good news out the way ……..

The media is always keen to make us think that we need to worry about every minute piece of information 24 hours a day 365 days a year. There is a lot of print space to fill and an incredible amount of airtime to pad out with pundit's analysis and predictions. "Well, Huw, as you know shares in Super Duper Plc fell by 0.01% today so investors really need to take immediate action to stop the losses before it's too late. Sell, Sell, Sell, it's the end of the world as we know it!" Of course another expert will come along tomorrow telling us that the same shares "look like great value just now and are very definitely a strong buy recommendation because……."

While the BBC are always delighted to tell us about the days when "billions of pounds were wiped off the value of investments today", they are not so quick to tell us the more boring truth about the long term trends; trends that occur across multiple asset classes over a variety of different time frames. Assets from Cash through to shares in Emerging Market companies tend to increase in value over time. Of course the news at any one point in time may be good or bad but over time things are rarely ugly.

During the Olympics there was virtually no news on TV except sport, the nation seemed to stop worrying about the state of investment markets and the economy, and markets quietly went up unnoticed. The FTSE All Share Index rose by over 5% between the opening and closing ceremonies. However, aside from the Olympic oasis the general sentiment about investments at the moment is still pretty negative. Many people don't really know what is happening to their investments and that worries them.

On Friday last week I asked several people to estimate the total return from the FTSE All Share Index of UK company shares over the preceding 10 years. Some thought the FTSE had fallen in value (lost money) others thought it had perhaps gone up a little but nothing to write home about and certainly less than the return on cash.

Before reading any further try and answer the question yourself – what was the total return (including dividends) from the FSTE All Share Index^ over the last 10 years?

You might be surprised to learn that the UK stock market actually rose by 7.57% per annum over that period. In overall terms, that is the same as saying £100 grew to £207.39 or £10,000 grew to £20,739. The market more than doubled during a period where the news has been almost constantly negative and frightening.

The table below shows the returns from various well known investment markets over the 10 years to 10th August 2012. In the first column we can see the annualised return and in the second the value of £100 invested at the end of year 10. It is worth noting that cash (as measured by the Bank of England Base Rate) was eroded by almost £2 per £100 by the effect of inflation while all other asset classes gave a positive return even after deducting the effects of inflation.

Most people regard 10 years as a reasonably long investment period. However, the particular 10 year period above is only one of many such periods in history. The figures above only show one single snapshot. So what about the long term averages? Well, one study by professors Dimson, Marsh and Staunton tracks the returns on Cash, Bonds (fixed interest investments such as loans to Governments) and Equities (company shares) from 1st January 1900. The latest update of the study covers a period of 112 years up to 31st December 2011. The study gives an insight into the returns from 21 different countries and a range of combinations such as Europe, the World or the World Excluding America. The table overleaf shows the long term returns for Cash, Bonds and Equities for the UK, US and World before and after inflation.

	10 Year Annual-ised Return	Final Value of £100
Index : Bank Of England Base Rate TR in GB	3.1%	£ 135.55
Index UK Retail Price Inflation TR in GB	3.2%	£ 137.46
Index : FTSE Small Cap Index (ex IT) TR in GB	5.3%	£ 168.30
Index : S&P 500 TR in GB	5.5%	£ 170.72
Index : FTSE British Government All Stocks TR in GB	6.3%	£ 184.38
Index : Hang Seng in GB	7.0%	£ 196.43
Index : FTSE World Index TR in GB	7.3%	£ 203.04
Index : FTSE World EX UK Index TR in GB	7.4%	£ 203.35
Index : FTSE All Share TR in GB	7.6%	£ 207.39
Index : FTSE British Government Index Linked All Stocks TR in GB	7.7%	£ 210.73
Index : MSCI EM (EMERGING MARKETS) TR in GB	15.3%	£ 415.91

You can see that the average return on world stock markets has been around 8.5%pa (nearly 5.5% above inflation). The UK and America performed slightly better than average but were by no means the best performers – South Africa Returned 12.5%pa and Finland returned 12.6%pa. Who would have thought in 1900 that Finland was going to provide the biggest return to investors over the next 100+ years? As the saying goes – "making predictions is difficult, especially when they concern the future".

Some further digging shows that it was a bit of a "game of two halves". The first half was generally below average (a Great Depression and two World Wars obviously contributed) and the second half above average. The most recent history is below average once again but that won't come as a surprise given the constant barrage of bad news on TV.

1900 - 2012
Nominal Returns (i.e. before inflation)

	Cash	Bonds	Equities
UK	5.0%	5.5%	9.4%
US	3.9%	5.0%	9.3%
World	3.9%	4.8%	8.5%

1900 - 2012
Real Returns (i.e. after inflation)

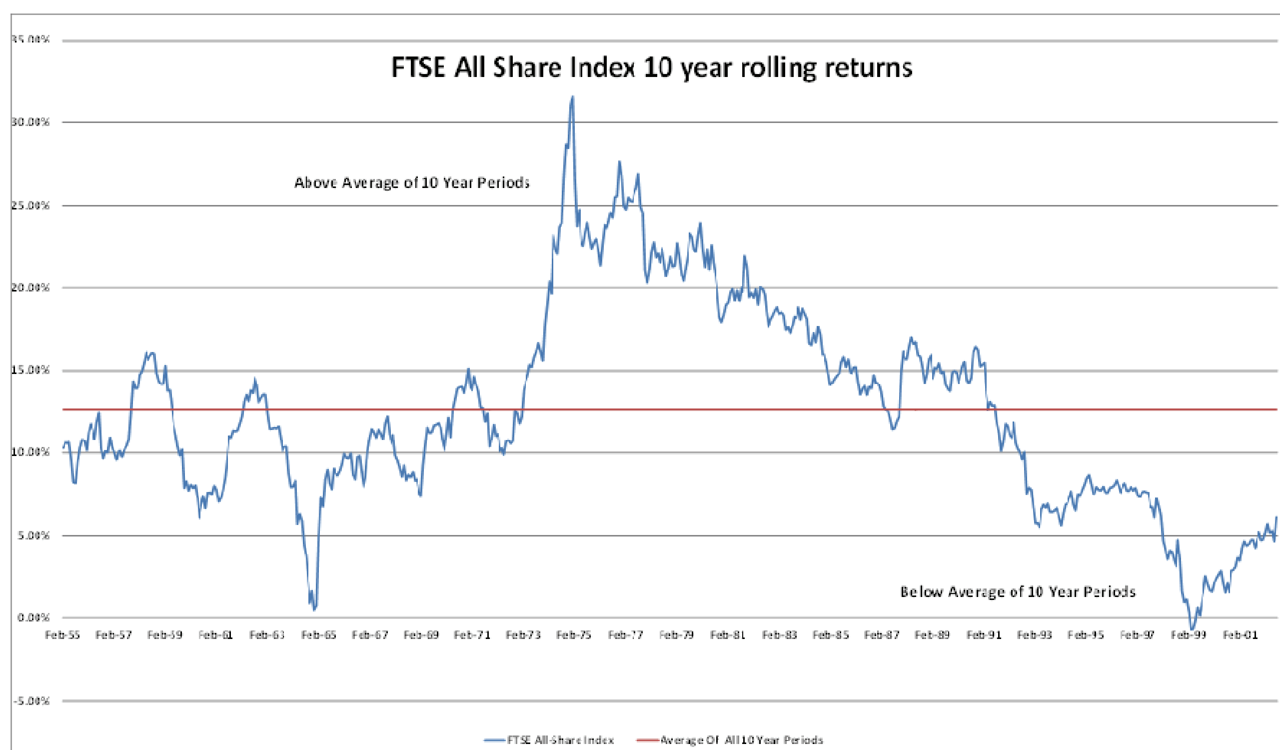
	Cash	Bonds	Equities	Inflation
UK	1.0%	1.5%	5.2%	4.0%
US	0.9%	2.0%	6.2%	3.0%
World	0.9%	1.7%	5.4%	3.0%

Investment markets have a tendency to revert to the long term average over time. Unfortunately, this is not something that can be used to build an investment strategy that beats the market – although countless people have tried! However, it does give a useful context for the current climate and gives an indication of the longer term prospects.

If recent 10 year average returns are significantly above the overall 112 year average it might be possible that future returns could be lower than average for some time until things even themselves out. Likewise, if returns are currently significantly below the long term trend it might be reasonable to expect a period of above average returns at some point in the foreseeable future. As I have already stated, it is impossible to predict when such a period of above average performance may start and end or what the trigger might be that leads to a change in fortunes.

I have analysed the FTSE All Share index returns from inception in February 1955 until July 2012. By using a period of 10 years to represent an average long term investor we can split the period into multiple 10 year periods and get a better idea of the range of potential outcomes. The first period runs from the start of February 1955 to the end of January 1965. The second period runs from the start of March 1955 to the end of February 1965, and so on. This gives us 570 overlapping (rolling) 10 year periods to compare. The average of all 10 year periods was 12.6%pa. However, real people rarely receive the average return; they either do better or worse than average depending on when they actually invest and withdraw their money.

The chart below shows the returns for each 10 year period plotted against the average of 10 year periods. Where the BLUE line is below the RED line investors received a below average return. Where the BLUE line is above the RED line investors received an above average return.

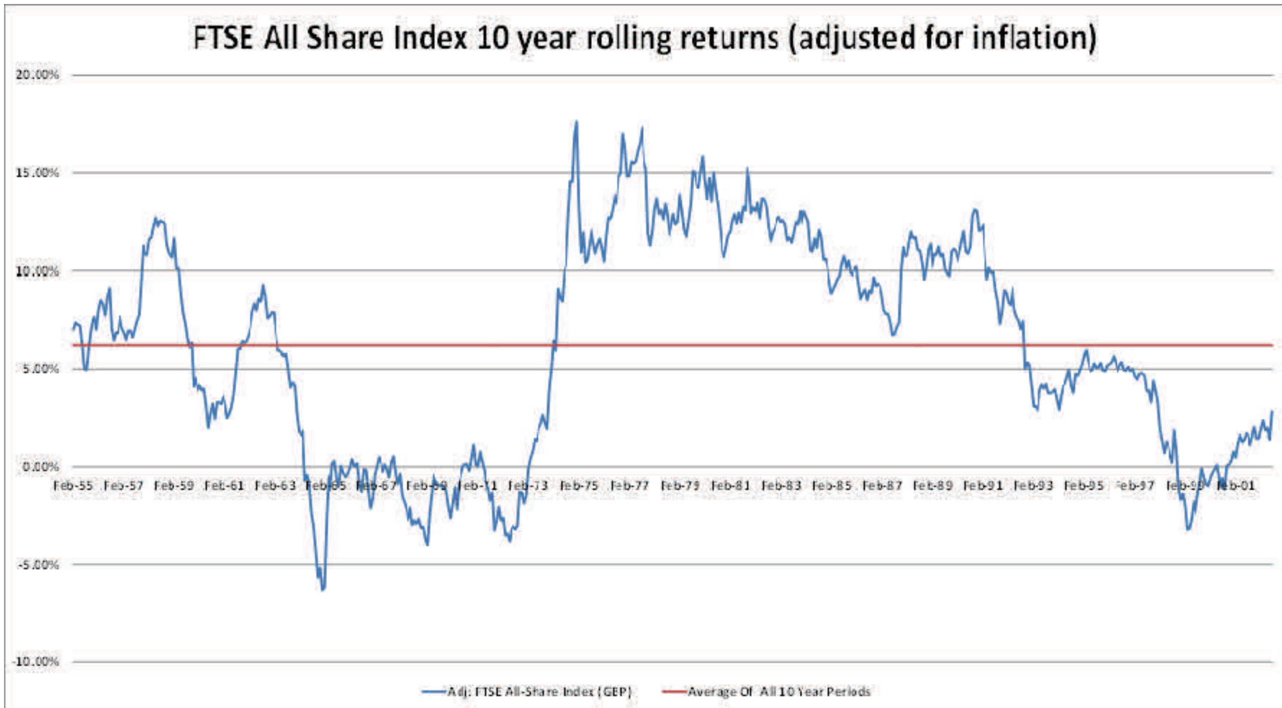


Some examples might help to decipher the chart. Let's assume Jim invested on 1st Feb 1955 (the furthest left point on the chart). He would have received a return equivalent to just over 10% each year over the next 10 years. This is slightly below the 10 year average of 12.6%pa. However, Charlie delayed investing until 1st July 1955 and only received a return of 8.3%pa over the following 10 years. Mick was really unlucky and invested in December 1964 most of his returns were wiped out by the stock market crash in the last two years of his 10 year period. While he enjoyed some excellent returns in the late 60's and 1971, the FTSE fell by nearly 30% in 1973 and a further 50% in 1974 (at total loss of 65% over two years). However, even Mick would have enjoyed a return of 12%pa (only marginally below the average for the full term from 1955) if he held his investment until July 2012.

On the other hand the luckiest investor in our sample, Mel invested in January 1975 (after the bottom of the market collapse and just in time for the recovery). Mel enjoyed an annual return of 31.6% which in technical terms is A LOT. In fact this would have turned an investment of £100 into £1,558 over 10 years.

The recent 10 year window from July 2002 to June 2012 saw a return of a little over 6% per annum. This tells us that the returns of the last 10 years have been about half the average level since 1955.

As we pointed out earlier though, the returns in the second half of the 20th Century were higher than the first half. Part of this is simply a reflection of the fact that inflation was very high for much of the period. Therefore, it is worth looking at the same chart after inflation has been taken into account to see a more realistic picture. While the shape of the graph is exactly the same as before, you can see that anyone investing after 1964, until early 1973, typically saw a negative return on their investment after inflation because inflation was running close to 15%pa during the 1970's. Unfortunately, this high inflation hammered cash savings just as badly as shares.



Some readers have suggested that this might not be detailed enough as the current situation is perceived as being worse than anything we have seen in our lifetime. What if the situation in Europe is more like the 1930's Great Depression than anything we have seen since the 50's? As we saw earlier in this article, the very long term data (112 years) for the UK and US is quite similar. We have monthly data for the US markets going back to 1926 and this does catch the Great Depression and World War II as well as numerous other "crisis". The chart below shows the trend for the US. Once again, the RED represents the average 10 year return for all periods under review. Each point along the BLUE line shows the return for the following 10 years for the US stock market. If the BLUE line is below the RED line, investors achieved a below average return. If the BLUE line is above the RED line investors did better than average.

The average 10 year return for the American stock market was 10.5%pa. The most recent 10 year period produced a return of 5.3%pa.

It is possible to take two things from this analysis:

1 – the return from stock market investments in recent years has been well below the long term average but in most cases it has still been better than cash and inflation

2 – current investment returns are around half the historical average. If markets do genuinely return to some form of long term average over time we must expect a period of above average returns at some point in future.

It is also clear that even given a 10 year horizon some investors would have lost money investing everything in the stock market. As it isn't possible to predict the future of any individual investment or investment market the best strategy is to carefully construct and maintain a diversified investment portfolio holding all of the main asset classes in a proportion that matches your own risk profile and the requirements of your financial plan. This should continue to be reviewed regularly and rebalanced back to the agreed target allocations as required. Fortunately, all of our clients hold well diversified portfolios of low cost funds specifically designed to capture the market returns over time but not everyone is in this position.

^The figures through out this article reflect the change in the value of commercially available Index such as the FTSE All Share Index. Figures are quoted in Total Return (TR) terms which includes reinvested dividends. They do not reflect actual investment returns to investors as investors cannot invest in an index itself. The index itself has no reduction for charges or taxation. It is possible to invest in a simple low cost fund which tracks the performance of the index less fees.

Past performance is not a guide to future performance, The value of your investment can fall as well as rise. You may not get back the original investment amount.

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