Weekly Digest
16 April 2018

Investec Wealth & Investment

The weekly insight into world stock markets

Long-Term Thinking

It is a source of continuing aggravation to me that I seem to spend at least as much time commenting on the whims of politicians as on the performance of economies and companies. The current period, characterised by a constant stream of tweets, sound-bites and poorly conceived policies makes for a febrile environment, with the increased levels of volatility encouraging such headlines as this one I saw on one of the financial news channels last week: "Dow Jones Average Breaks Two-Day Winning Streak"! Short-termism gone mad.

So it came as something of a relief to see the publication of Barclays' Equity Gilt Study, a document that has been produced annually since 1956 and which has UK market data extending back to 1899. We are strong advocates of the long-term benefits of investing in equities, so it is reassuring to see that since the end of the nineteenth century UK equities have delivered a real return of 5.1% per annum, far outstripping both long-dated Gilts (1.3%) and Cash (0.7%). Of course, over a shorter period, a lot depends on when the snapshot is taken, and equities don't come out quite as well on a ten or twenty year view, underperforming Gilts over both periods. The ten-year returns include the financial crisis and the twenty-year returns also include the Dot.com bust. Even so, it is consoling that equities still delivered a 3.2% real return over both periods despite halving twice.

Much is made of the greater volatility of equities, and that cannot be denied. The distribution of annual equity returns is far larger than for Gilts and Cash, but, as Benjamin Graham counselled, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." The revenues, profits and dividends of companies tend to grow in line with the nominal growth of the economy over time, whereas Gilts, (held to maturity) will only return the yield indicated at purchase; so the longer you can stay invested in equities, the better. In fact, as long as one has held onto UK equities for at least twenty-three years, one has never experienced a negative real return, whereas inflation has sometimes inflicted real losses on holders of both Gilts and Cash over that duration. So if I stick to equities I should be able to afford the candles on my 80th birthday cake!

Something else that jumps out from the data is the extraordinary performance of all three asset classes in the periods 1977-1987 and 1987-1997. The real returns for Equities, Gilts and Cash respectively were 12.0/4.5/3.4% and 10.4/6.9/4.6%. I have noted before that the best twenty-year rolling period I can identify post-War for balanced portfolio returns is 1980-1999, so this isn't entirely surprising. Starting from a position of high inflation, high interest rates and low valuations was the key to future strong returns, and this was bolstered by financial sector deregulation. What the data does not reveal, though, is that this was a period during which equity and government bond returns were generally negatively correlated, meaning that it was very rare to lose money in both asset classes simultaneously, and so balanced portfolio investors had a very smooth journey. The high starting yield for Gilts boosted the income component for bond investors, and we often point out that the current 10-year yield of 1.4% leaves all the onus for real returns on capital gains – and they are hard to see materialising from here unless there is sharp slowdown. Such an outcome would not, in our opinion, bode well for equities. There is some concern currently that an acceleration in inflation could lead to sharply higher bond yields and lower valuations for equities, thus delivering losses all round, much as we saw at the beginning of February. Whichever way you cut the numbers, it's very hard to see the same sort of returns ahead as were generated in the 1977-1997 period.

Another nice feature of the report is the emphasis on reinvested income. An equity investor who spent all their dividends would have seen £100 in 1899 turn into £203.71 today, allowing for inflation (and Gilts would have left you with just 73p!!). Reinvesting income would have produced £34,758 (and £484 for Gilts). Obviously reinvestment of income is much more viable for those who are still accumulating wealth rather than for those who are in retirement, so personal circumstances must always be taken into account when making financial plans.

While on the subject of playing a long game, several people have employed Game Theory to analyse the potential outcomes of current market-moving events, and it certainly helps to explain how investors react to news. In the context of the current Trade War threats, if one looks at this as a "Prisoner's Dilemma", it is almost inevitable that both sides act aggressively because if one backs down the relative loss is enormous. In a world of chest-beating politicians, neither side will want to lose face. However, this assumes that there is only one "game". The reality is that there are multiple games, and that each one allows for new information and for both sides to move towards a more conciliatory conclusion while being able to declare themselves winners. This is what the market (after an initial panic) is now discounting as the outcome to the trade spat. Of course, that also means that if there is no face-saving agreement, we are in for a tougher time. This was also the playbook for the nuclear scare involving North Korea last summer, and it was notable how quickly markets calmed down then.

Finally, it was Charles Howard, 1st Earl of Nottingham who commanded the English fleet against the Spanish Armada in 1588. This week, which British fashion designer was born in Nottingham in 1946??

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Micro Focus International	15.1%
Tesco	14.1%
Just Eat	6.9%
GKN	6.9%
Whitbread	6.7%
Rio Tinto	6.3%
DS Smith	5.9%

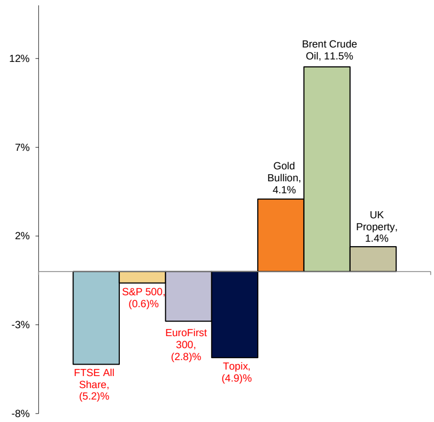
Source: FactSet

FTSE 100 Weekly Losers

Evraz	-12.9%
Coca-Cola HBC AG	-7.9%
Sage Group	-5.9%
British American Tobacco	-4.5%
Imperial Brands	-3.6%
Carnival	-3.3%
Reckitt Benckiser Group	-3.3%

Source: FactSet

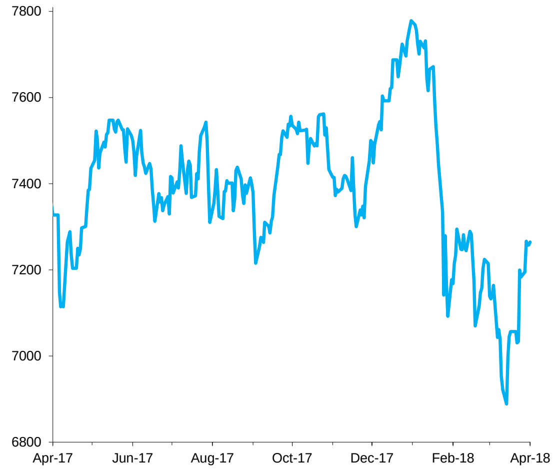
Year to Date Market Performance



*Lagged to latest UK IPD Total Return All Property Index (Feb 2018)

Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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