Volume 15 //

Acuity

The greatest wealth is **your peace of mind...**

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WEALTH MANAGEMENT

Spotlight on equities

> 'The selfish spirit of commerce knows no country, and feels no passion or principle but that of gain'
>
> Thomas Jefferson, 1743-1826, 3rd US President

Sometimes owning equity investments can seem disjointed from the real world. It is not. You are an actual owner of real companies and you need to have a good sense of both where returns come from and the risks that accompany ownership. Many investors have a deep seated unease about when to invest their money in the equity markets. The real question they should be asking themselves is not when they will invest, but when they will need to start withdrawing their money in the future.

An introduction to equities

Most investors will have a broad idea about what equities are and how they tend to behave. The danger is that some forget that by holding equities in a portfolio, they become part owners of real businesses operating in a brutally competitive, complex and dynamic environment – the global economy. Thank goodness for that 'selfish spirit of commerce' that has driven wealth creation in the past and continues to do so today. This volume of Acuity seeks to provide a greater understanding of what owning equities means and what a little digging into equity market history can reveal.

What is equity?

At its simplest, a company can raise money to fund the expansion and development of its business, either by borrowing money or by selling a part of its ownership to someone who believes that their capital will be put to good use to deliver rewards that will make the risks of their 'share' of ownership worthwhile. This transaction may be carried out either on a private basis – known as private equity - or by a public offering of shares if the company is a 'public company' listed on a stock exchange. If a private company decides to raise money for the first time from the public markets and becomes 'listed' it does so via an 'initial public offering' (IPO) by issuing shares for sale, as Facebook did recently. This sale of equities to raise money for the company takes place in the primary market for the shares, via a subscription process.

Once publicly listed, the shares trade on the stock market and will be bought and sold by market participants such as mutual funds, brokers, pension funds, individual investors and hedge funds. This is known as the secondary market for the shares. Most investors hold the majority of their equity assets in publicly listed shares, which tend to be more liquid – that is, easier to buy and sell – than privately held equity stakes. Here, we will focus on the public markets.

Where do equity returns come from?

When an investor holds equity in their portfolio, they become the part owner of a company with the risks and rewards that go with it. The risks are evident. In extremis, companies fail and enter administration. In the pecking order of who gets to pick over the corporate carcass, the equity holder (owner) sits at the back of a long line of creditors, some of whom may have their liabilities secured against the company's assets, such as a lending bank. The higher risk of being an owner rather than a lender would imply that the returns should be higher too. If not, no-one would bother to be an owner in the first place.

Returns come from the hard work, strategy, fortitude and innovation of real people grinding their way into work each day to try and grow the earnings of the company that they work for, as an employee taking a wage or as an owner. Michael Porter, a well-known professor at Harvard, wrote a seminal book[1] about the competitive advantage of companies and their need to respond to five key forces to survive and thrive. These include the way in which a company handles the threat of new entrants, deals with the impact of substitute services or products, addresses the issue of the bargaining power of customers and suppliers and the intensity of the competition in the commercial space that it occupies. Some win and some lose – a good reason to be well diversified. The holder of the company's equity will be rewarded in two ways: by cash dividends paid out to each shareholder and by a rise in the price of the shares.

Reward 1: cash dividends - a major component of returns

Many investors get fixated on the price of their shares and the level of the market, such as the FTSE 100 Index – the 'Footsie' – which is a price index. What many investors fail to realise is that it is the reinvestment of the cash dividends back into the equity market that generates most of the above-inflation returns that the market has historically delivered over the longer term. The price level of shares just about keeps line with inflation. The figure below compares the FTSE All Share Index (a broader UK equity index) both with and without dividends reinvested, after inflation.

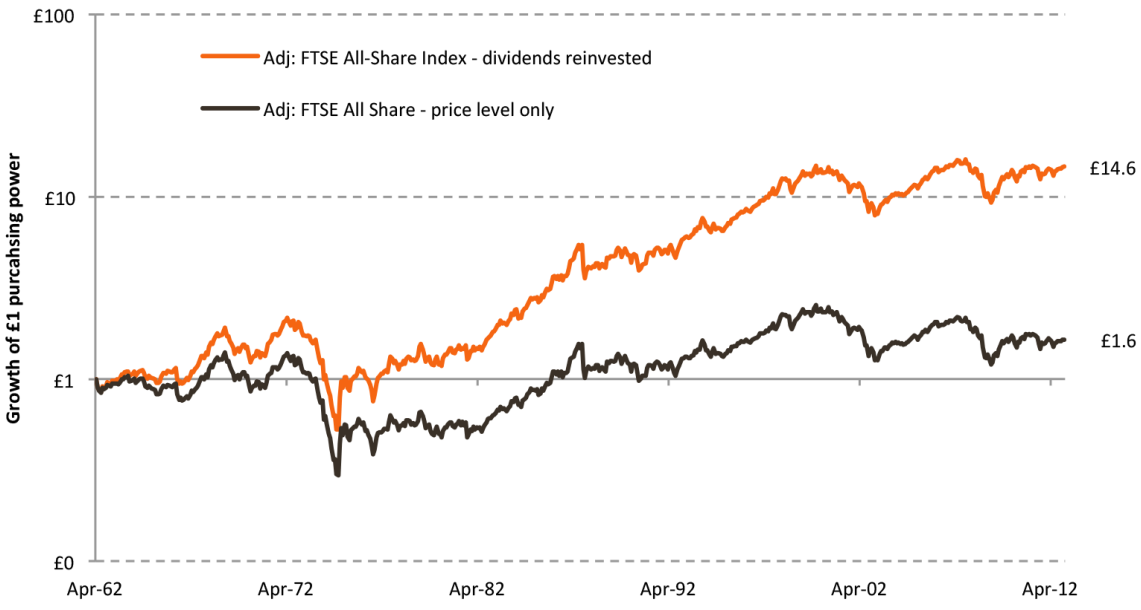

Figure 1: Dividends really matter – FTSE All Share Index (4/1962 to 12/2012)

Data source: Morningstar Encorr. Copyright. All rights reserved.

Currently, dividend yields on the FTSE All Share are in the region of 3.6%. Dividend yields vary depending upon the height and depth of the market ranging from around 2% to over 5% at times.

Reward 2: a rise in the share price

The second way that investors are rewarded is through the rise in the price of the shares that they own. Share price rises are made up of two elements: these are the rise in the earnings (profits) of a company after inflation and the multiple of these earnings that an investor is willing to pay for each £1 of earnings. This multiple is known as the price-to-earnings ratio – or P/E ratio for short. A company with £100 million of earnings which investors are willing to buy at a multiple of 15 times (i.e. its P/E ratio is 15) has a value of £1.5 billion. If the P/E ratio of a company stays the same and its earnings rise, the share price will go up. In the example above, if the company's earnings go up by £10 million to £110 million and the P/E ratio is still 15 then the company will be worth £1.65 billion. If the P/E ratio rises, the same earnings will deliver a higher share price and vice versa. Today, the P/E ratio of the market is around 13 times earnings.

Total returns: dividends plus price rises

Over the longer-term – the longest data is from 1900 – equities, on a total return basis, have delivered a return above inflation of around 5% in the UK and in aggregate globally, although some markets have fared better and some worse. Bonds over this period have delivered a little over 1% above inflation, although over the past thirty years they have delivered materially higher returns that are unlikely to be repeated going forwards.

Attractive long-term returns come with shorter-term uncertainty

The challenge that investors face is that equity returns come with a high degree of uncertainty from one period to the next. The following sequence of figures illustrates this clearly. The first looks at annual returns from 1970 to the present for global developed equity markets. Equity markets are volatile.

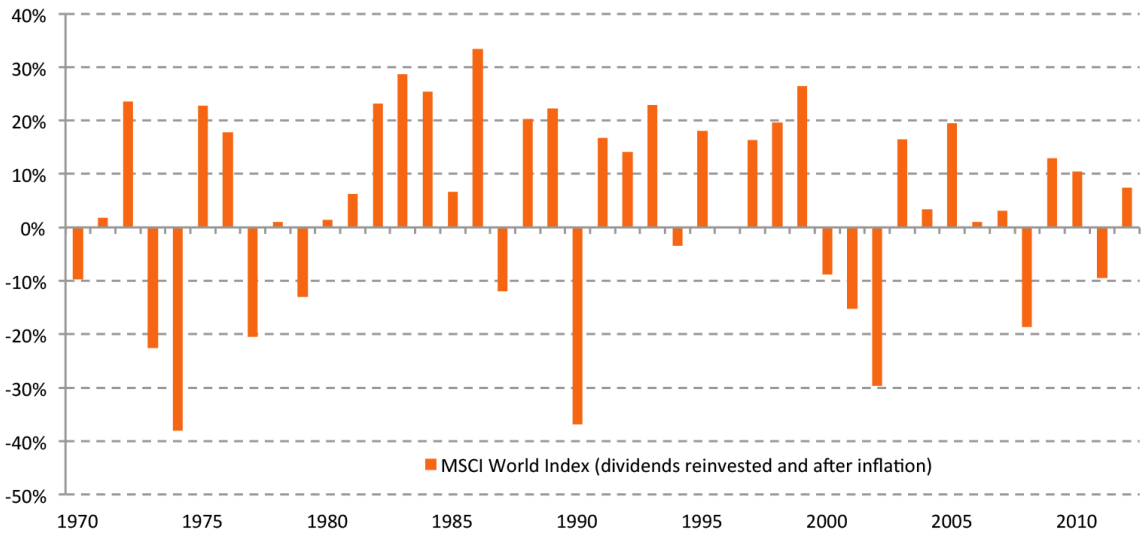

Figure 2: Annual returns are volatile – MSCI World Index (1970 to 2012)

Data source: Morningstar Encorr. Copyright. All rights reserved.

This same data can also be looked at in terms of the distribution of returns by outcome. It is evident that owners of equities have to put up with some pain in order to obtain the longer-term rewards on offer. From eye-balling the chart above, it is plain that some decades have delivered better returns (1980s and 1990s) than others (2000s).

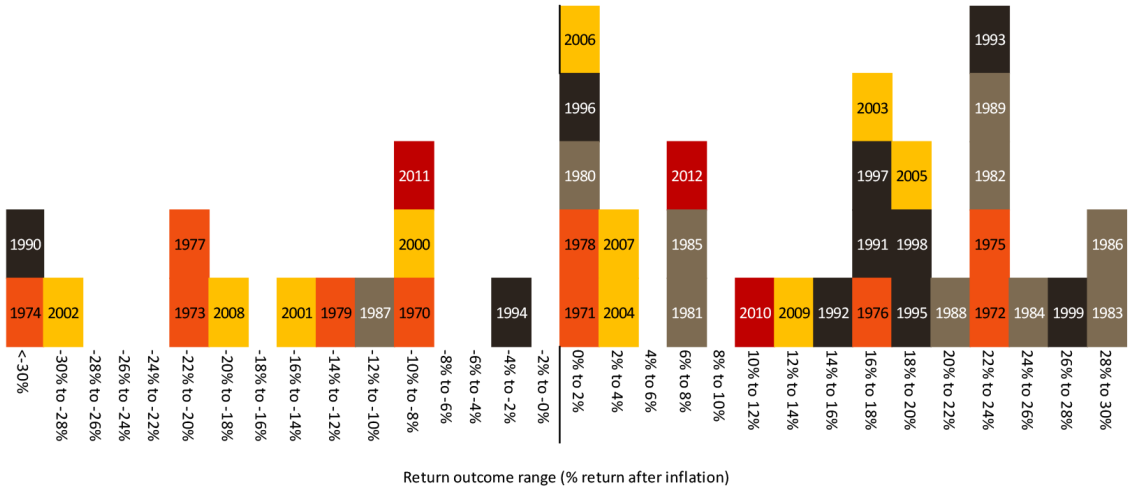

Figure 3: The range of annual returns is wide and unpredictable

Data source: Morningstar Encorr. Copyright. All rights reserved. MSCI World Index (1970-2012).

Looking at the different holding periods (time frames that investors may be investing for) and identifying the best and worst returns that would have occurred, provides further proof that equity investing is not a short-term game.

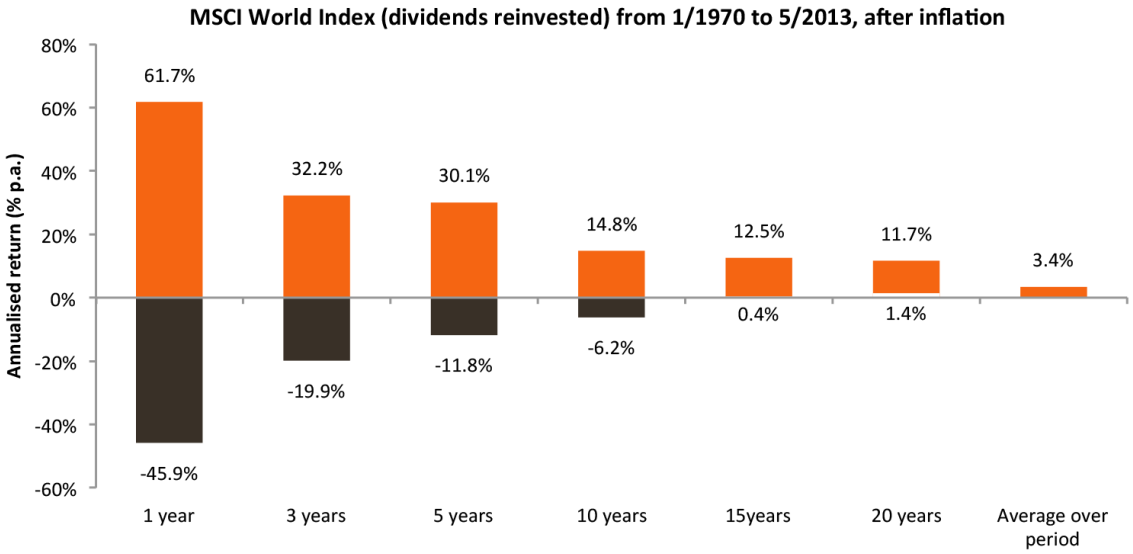

Figure 4: Annualised returns by holding period

Data source: Morningstar Encorr. Copyright. All rights reserved

When is a good time to be invested in equities?

This is the perennial question that all investors ask themselves. Those with a greater insight into the uncertainty of the future tend to realise that the decision is not binary i.e. all or nothing. In reality it is about accepting the uncertainty that comes with the territory and trying to survive the down period to achieve the strong inflation-plus returns that equities can deliver. Sensible investors protect themselves from these falls by balancing the risks of ownership with high quality, shorter-dated bonds that are materially less uncertain in their outcome and will stand up strongly as defensive assets at times of equity market trauma.

The astute and interested reader may question whether using P/E ratios or dividend yields as a guide to valuing markets can help make market timing decisions of when to buy and sell. Many investors have failed trying and the academic evidence[2] would suggest that, for most, a buy-and-hold approach makes better sense and delivers a higher probability of a favourable outcome.

Perhaps the right question is not when is a good time to be getting into equities, as it is extremely hard to measure accurately the value of the market, but rather: how long has an investor got before they need their money? By and large investors with shorter horizons are rolling the dice by owning too much equity, as the chance of a negative outcome is higher. Longer horizons provide the likelihood, but not a guarantee, of more positive outcomes.

The figure below illustrates that the starting point is less important that the exit point, given that it is hard to predict if the market is overvalued or undervalued, and market-timing calls tend not to work effectively. The vertical axis is the start date and the horizontal axis is the exit date. For example, an investment in global equities at the start of 1973 would have suffered some severe losses in the first few years, but would have been back in positive purchasing power territory with a return of 0.3% p.a. by the end of 1984. At a horizon of 20 years (1992) the investment would have returned 2.4% p.a., which would have turned £100 into £161 of purchasing power (i.e. after inflation). Not a bad result given the terrible starting point.

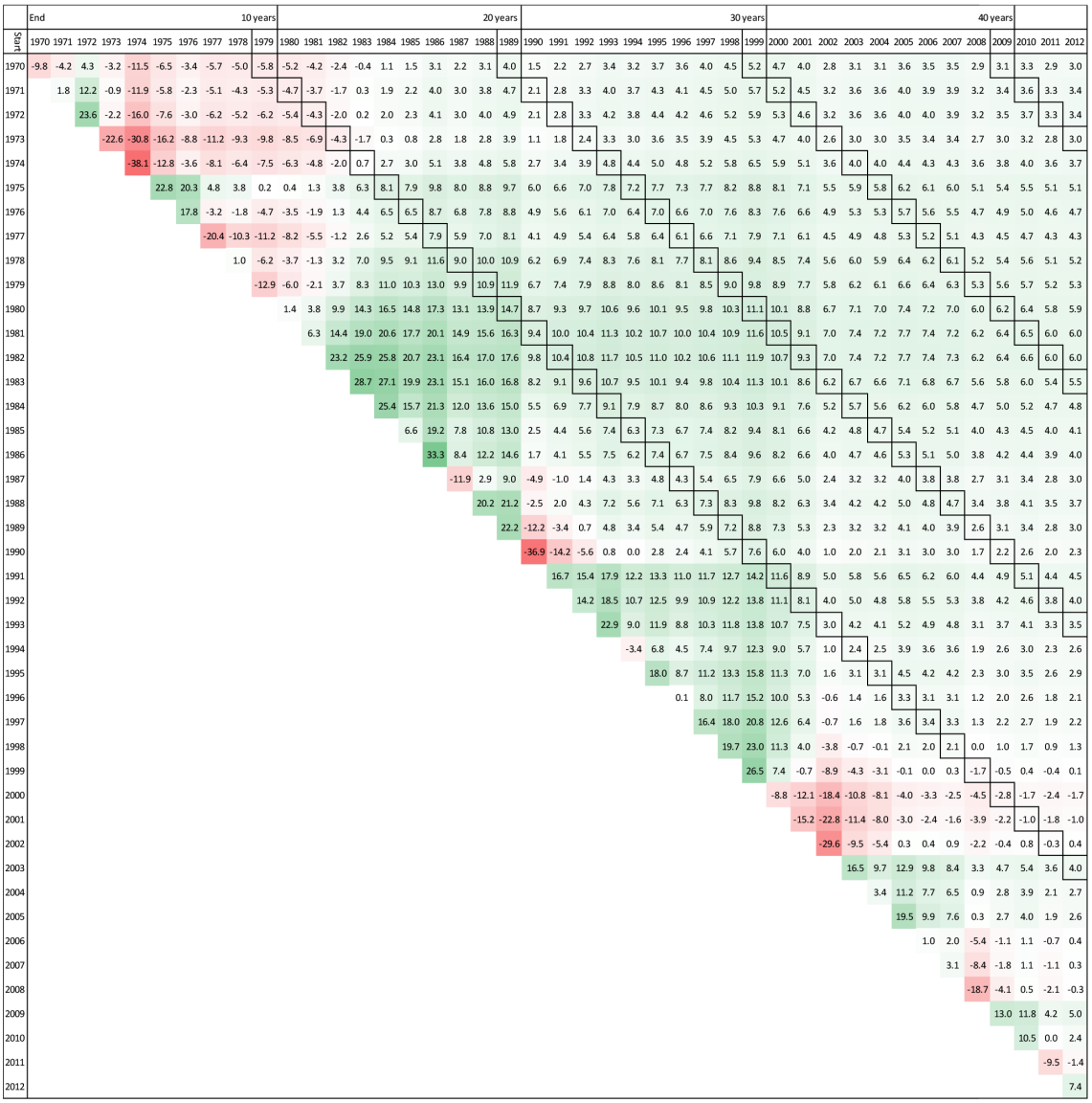

Figure 5: It is not when you start that matters most but how long you have got

Data source: Morningstar Encorr. Copyright. All rights reserved. MSCI World Index adjusted for UK RPI (1970-2012).

Conclusion

Given time, equity markets have the capacity, through 'the selfish spirit of commerce', to create wealth and overcome the material losses that can be suffered in the shorter term. Time helps to smooth out the exuberance and pessimism of investors, allowing the true economic rewards of equity ownership to shine through.

Owning a diversified portfolio balanced between equities from around the world — capturing the aggregate energy and dynamism of companies generating earnings in different countries and continents — and high quality, lower risk bonds makes sense for most.

End notes

1. Porter, M.E. (1980) Competitive Strategy, Free Press, New York, 1980.
2. Two academics, Amit Goyal and Ivo Welch undertook a review of a wide range of market valuation measures to see how effective they were relative to a buy-and-hold strategy. Their overriding conclusion is that ***'these models would not have helped an investor with access only to available information to profitably time the market'***.

   Goyal, A., Welch, I., (2007), A Comprehensive Look at The Empirical Performance of Equity Premium Prediction, The Society for Financial Studies, available at www.chicagobooth.edu

Other notes and risk warnings

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