Shane Oliver, Head of Investment Strategy & Chief Economist

Have shares lost their appeal for long term investors?

EDITION 23 – 19 JULY 2012

Key points

- While rolling ten year periods occasionally see shares underperform bonds and cash, this is rarely the case over 20 year periods, and has never been the case over 40 year periods.
- The high returns from cash and bonds over the past 30 years or so won't be repeated as starting point yields are now much lower than was the case in the 1980s.
- The current period of poor returns for shares is not particularly unusual - investor sentiment is doing what it normally does after an extended bear market in shares. It is dangerous to conclude "this time it's different" and that shares will no longer provide a higher long term return.

Introduction

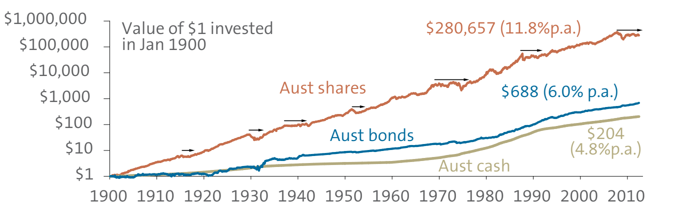
After several years of poor performance, shares are exhibiting good value, particularly against record low bond yields and low and falling cash rates. Against this, the investment backdrop remains as messy as it's ever been over the past few years. Europe is continuing to muddle along with many fretting it will blow apart. The US is going through a soft patch with concerns about a 'fiscal cliff' later this year. Key emerging countries have also slowed. While the Australian economy is doing better than many, the share market seems to be exposed to parts of the economy that aren't doing well. As disappointment piles on disappointment and the years roll by it is no surprise investors are starting to give up and focus on preserving capital as opposed to seeking growth.

Given this, is the "stocks for the long term" approach still valid? Are long term investors right to sit tight?

History is on the side of shares

It is well known that over very long periods of time, shares have provided superior returns to most alternatives such as cash or bonds. This can be seen in the following chart, which shows that since 1900, Australian shares have returned nearly 12%p.a. compared to 6%p.a. for bonds and 4.8%p.a. for cash.

Shares versus bonds & cash over very long term



Arrows show long bear markets in shares. Source:Global Financial Data, AMP Capital

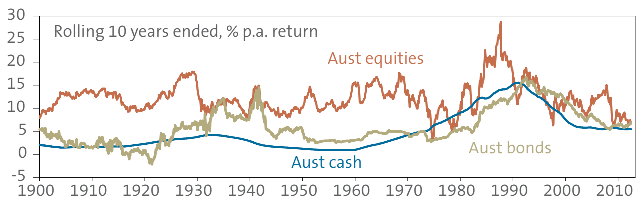
In fact, due to the power of compound interest, A$1 invested in 1900 would have grown to A$280,657 today if invested in shares, compared to A$688 if invested in bonds even though the return on shares was just less than double that of bonds. The story is the same for the US, albeit not quite as impressive. Since 1900, US shares have returned 9.5%p.a., compared to 4.5%p.a. for bonds and 3.6%p.a. for cash.

But of course no one has a 110 year term to invest over. And some might observe that the steepness of the lines for cash and bonds has increased since the 1970s relative to shares.

But investors don't have 110 years?

Of course investors don't have 110 years, so it may be argued that the previous chart is irrelevant. This is not so. The next three charts show the rolling annual returns over 10, 20 and 40 years ended at the dates shown in the horizontal axes. Over rolling ten year periods, while shares have invariably done better, there have been periods in the 1930s/early 1940s and since the 1970s where returns from bonds and or cash have done better. Over the past decade shares have performed only marginally better than bonds.

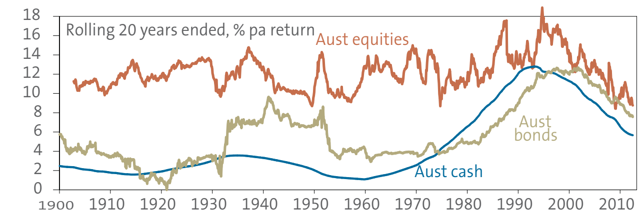
Investment returns over rolling 10 year periods – Australia



Source: Global Financial Data, AMP Capital

Pushing the horizon out to rolling 20-year periods has invariably seen shares do better than cash and bonds, although a surge in cash and bond returns from the 1970s/early 1980s has seen the gap narrow and there have been some years where returns over the prior 20 years have been better from bonds than shares. However, this has been the exception. Over the last 20 years, shares have returned 8.8%p.a., versus 7.6%p.a. from bonds and 5.7%p.a. from cash.

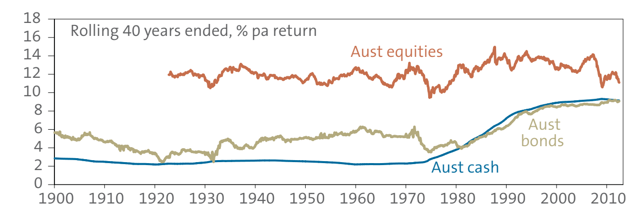
Investment returns over rolling 20 year periods – Australia



Source: Global Financial Data, AMP Capital

Over rolling 40-year periods - representative of the working years of a typical person, share returns have been remarkably stable in a range of around 12%p.a. While rolling returns from bonds and cash have picked up since the early 1980s, shares have always done better.

Investment returns over rolling 40 year periods – Australia



Source: Global Financial Data, AMP Capital

It can be seen that while shares don't outperform cash and bonds over all ten year periods, they invariably have done so over

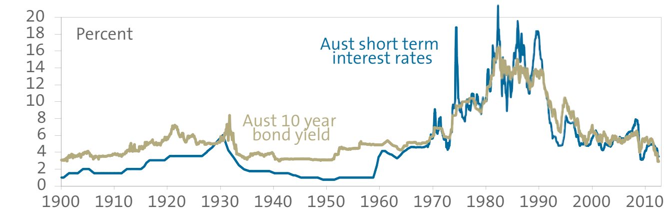
20-year periods and have always done so over 40-year periods. This is consistent with the basic proposition that the higher short term volatility or risk from shares (reflecting the exposure to periods of falling profits and a real risk that companies go bust) is rewarded over the long term (defined as beyond 10 years) with higher returns.

But what about the higher returns from cash and bonds since the 1970s?

There is no doubt that periods since around 1980 have seen a narrowing in the gap (or the risk premium) between share returns and bond and cash returns. However, it would be dangerous to conclude that this is a guide to the future.

Returns from cash were pushed up in the 1970s when cash rates and other short term interest rates rose on the back of high inflation. Through the 1980s, short term interest rates averaged 14.5% and term deposit rates averaged around 12.5% in Australia. In the early 1980s, bond yields reached double-digit levels, in fact reaching a record 16.4% in 1982. This led to very high returns from both asset classes over periods due to such high yields.

Very high interest rates boosted cash and bond returns over the last 30 years. They are now back to very low levels.



Source: Global Financial Data, Bloomberg, AMP Capital

The decline in bond yields from the early 1980s was driven by the adjustment from high inflation to low inflation and more recently by worries about global deflation. This has generated huge capital growth and hence, attractive returns for bond investors.

However, the days of high returns from cash and government bonds are fading. If you buy an Australian ten year bond today and hold it to maturity you will get 2.9%p.a. The official cash rate is just 3.5% and bank term deposit rates are averaging below 5%.

But what if the current period is different?

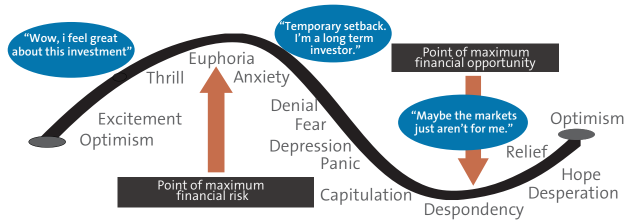
It is always possible that we have entered a "new era" of permanently poor returns from shares. But history cautions against such thinking. As the investor, Sir John Templeton, once observed, "the four most dangerous words in investing are: 'this time it's different'". Claims of new eras of permanently higher returns from shares were seen at the end of long term bull markets in the late 1920s, late 1960s and late 1990s – only to look nonsensical a few years later.

Similarly, after a decade of poor returns, Business Week magazine concluded in 1979 that we have seen "The Death of Equities" with the argument that after a decade of poor returns, investors had abandoned shares for good. Then, through the 1980s and 1990s shares moved through a strong bull market.

While the current poor patch for shares may seem unusual, in a historical context it is not. In many ways it actually resembles the 1970s. Both periods suffered from the excesses of a long period of high returns and dysfunctional economic policies.

While cycles vary, investor thinking is very much following the roller coaster of investor emotion devised by Russell Investments many years ago. The diagram below shows how investor psychology evolves through investment cycles. During a bull market, 'optimism' eventually gives way to 'euphoria'. When a bear market begins, investors initially see it as a short term setback and remind themselves that they are long term investors. But as 'anxiety' gives way to 'fear', investors eventually become 'despondent' and 'capitulate' by selling their investments, thinking that maybe shares aren't for them.

The roller coaster of investor emotion



Source: Russell Investments, AMP Capital

The longer the down cycle, the greater the capitulation and despondency and this is arguably what we are seeing now. This is akin to what we saw through the 1970s bear market in shares which eventually led to calls of the "death of equities".

But as long as the capitalist system continues and economies eventually recover, history tells us that shares will eventually bounce back and there is no reason to doubt that over long periods they will provide higher returns than cash and bonds. With grossed up dividend yields on Australian shares above 6% at a time when cash and term deposit rates in Australia have fallen well below 5% and bond yields have fallen to record lows, shares only need modest capital growth to easily outperform.

So what does this mean for investors?

The key points are that the current period of poor returns for shares is not particularly unusual, investor sentiment (and cash flows) is doing what it normally does after an extended bear market in shares and it is dangerous to conclude that shares will no longer provide a higher long term return than cash and bonds. Putting aside the case for asset allocation in a more volatile world, for those with a long term investment horizon, it still makes sense to stick to agreed strategies involving a bias to shares, even though they have failed to deliver over the past few years.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.au, or contact one of the following:

Financial Advisers	Your Business Development Manager or call 1300 139 267
Personal Investors	Your Financial Adviser or call us on 1800 188 013
Wholesale Investors	AMP Capital's Client Services Team on 1800 658 404