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Equities for the long-term #2

Westminster Assets Management's Investment Strategist Peter Lucas considers tactical approaches to equity investing with an analysis of historic market data.

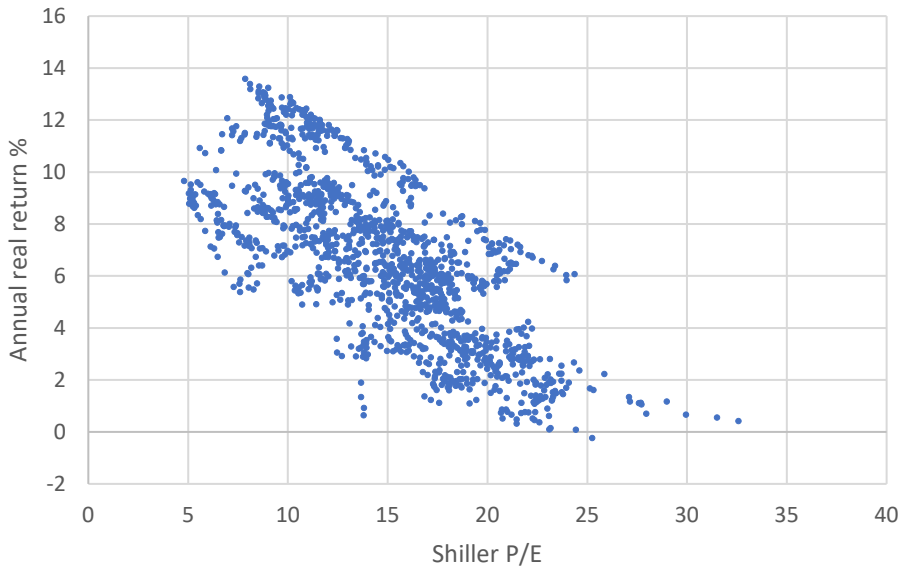
Having presented the long-term case for equities in our last article, we now look at some of the tactical considerations that can make equity investing even more rewarding (or less risky), particularly over shorter holding periods.

We have demonstrated that investors have almost always generated positive real terms from US equities. But for many, a barely positive real return over a twenty-year period would be a very disappointing outcome, particularly given equities' long-term track record of 6-7% per annum. Although there are numerous factors that cause equities to over- and undershoot their long-term averages, arguably the three most important are: valuation, inflation, and recession.

Of the three, valuation is arguably the most useful, particularly for those with a truly long-term time horizon. Well-defined valuations can provide investors with good estimates as to what sort of performance they can expect over the very long term. Consider the scatter graph below, which demonstrates a clear inverse relationship between US equity valuations (in this case the Shiller P/E) and forward 20-year real returns. In other words, high valuations are generally associated with low or even negative real investment returns (with income reinvested). This information can be used to avoid assets that are at risk of producing sub-par returns.

Chart 1: 20-year forward real returns vs Shiller P/E (1881-1996)

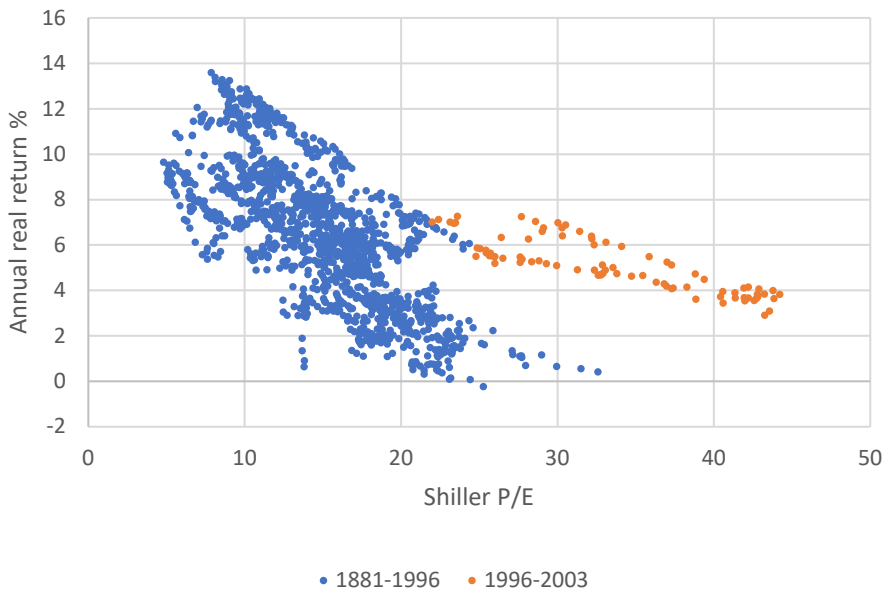
Source: Robert Schiller/Bloomberg/Westminster



That makes it sound easy, but there is a major caveat – valuation analysis is not foolproof. Over shorter periods it has limited forecasting power, and in exceptional circumstances, markets can seemingly rewrite the relationship between valuation and return. In other words, expensive markets can defy gravity for surprisingly long periods of time. The chart above shows the forecasting power of the Shiller P/E for the period 1881-1996. The chart below adds datapoints for the period 1996-2003 in orange, and it is quite clear that 20-year returns have been higher than one might have expected. In other words, valuations have not mean-reverted as much as one might have expected given historical experience. Nevertheless, the principle still applies, if you avoid expensive markets, you are less likely to experience sub-par performance, but it could potentially be at the expense of missed opportunities. US equities have outperformed virtually everything in the past 10-15 years despite being 'overvalued' for much of that time.

Chart 2: 20-year forward real returns vs Shiller P/E (1881-2003)

Source Robert Schiller/Bloomberg/Westminster



The chart below shows the Shiller P/Es for various countries and regions, together with global growth and global value shares. Note that these numbers are not necessarily comparable. For instance, growth shares generally trade on a premium versus their value equivalents. Hence, it is important to look at the size of the differential versus history rather than just comparing one to the other (although, as it happens, value is unusually cheap by historical standards).

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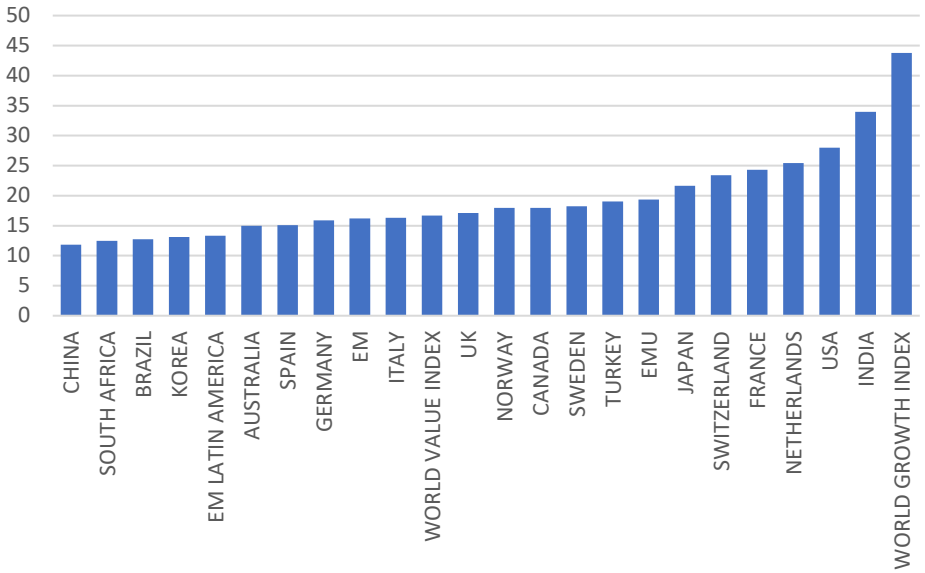
Chart 3: Shiller P/E by country/region

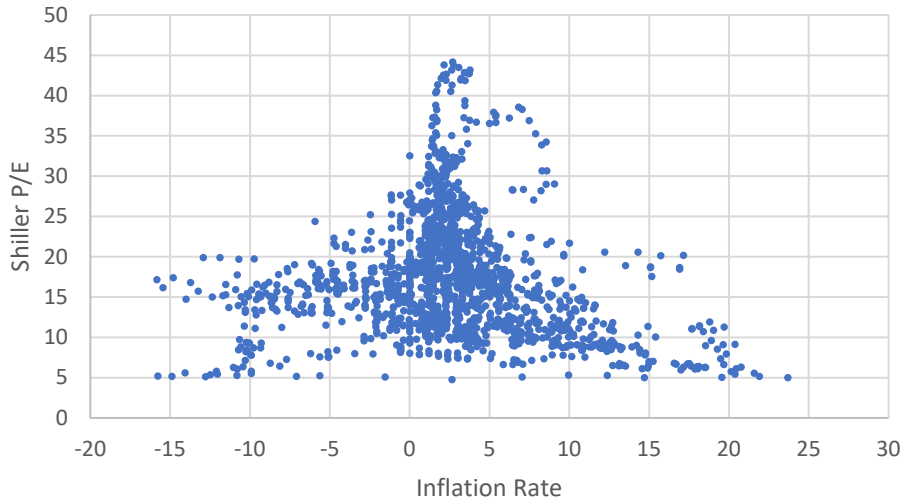
Source: Robert Schiller/Bloomberg/Westminster



At this point it is worth saying that overvalued markets rarely fall under their own weight – there is generally a catalyst that causes valuations to mean-revert. Which segues us nicely into a discussion about the other key variables: inflation and recession. The relationship between inflation and equities is multi-faceted and complex. As a rule, equities like inflation to be below 3-4%. Also, they like it when inflation is falling, unless it is at risk of moving into deflation (negative inflation) territory, which equities do not like. Equally, equities do not like rising inflation, unless it is rising away from deflation territory.

Chart 4: Shiller P/E vs Inflation Rate

Source: Robert Schiller/Bloomberg/Westminster



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The best way to explain the complex relationship between equities and changes in inflation is through the lens of valuation. The scatter graph above shows the relationship between the Shiller P/E and the headline inflation rate. There are at least three takeaways from this chart:

1. There is an inverse conical relationship between valuations and inflation, with the highest valuations generally associated with inflation in the range of 0-5%.
2. Valuations tend to drop as inflation moves out of the 0-5% range, in either direction.
3. If valuations are low enough, equities should be fine whatever inflation does.

The other scenario that is generally bad for equities is recession, or negative economic growth. Depending on the depth of the recession, equities generally experience corrections of roughly 20-30% due to a combination of falling company profits and lower valuations. Indeed, valuations display a similar inverse conical relationship with industrial production, with the highest valuations seen with real growth in the region of 0-10%. Lower valuations tend to come with negative growth (recession) and high growth (which can be inflationary). In short, equities perform best under 'Goldilocks' – when economic growth is neither too hot nor too cold.

In summary, absent defeat in war and other low probability catastrophes, owning equities is generally a good thing, at least in the long run. There are certain circumstances which can lead to sub-par returns, but they can be managed. Identifying expensive markets is relatively straight forward, even if the exact timing of sales and switches is not. Identifying inflation and/or recession risk is trickier but there are techniques that can be used to track them in real time, but that is a subject for another article.

Peter Lucas
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