

A decade of weak equity returns

A bad decade in equities does not mean that the asset class has no future, argues **Peter Hensman**. The future, however, remains extremely unpredictable, he admits.

Equities have suffered a torrid decade. According to S&P, the index of the 500 largest stocks in America lost 0.9 per cent per annum, including the impact of income in the period since the start of the Millennium. While this picture is hardly one that those attracted to equity investing in the late 1990s hoped for or expected, there is reason to argue that this statistic in itself is not reason to give up on equity investing.

First, weak equity returns over 10-year periods to the end of the 1970s were followed by strong gains in the 1980s. Based on data from Robert Shiller, the total return on the S&P over the course of the 1980s was 17.5 per cent per annum, as policymakers responded to the negatives that had undermined returns in the prior decade and sentiment toward equities as an asset class improved. Second, while this period has been a challenging one for equities, as returns on the S&P have had to work against the high valuations reached in the late 1990s, this overall performance masks the divergence within the market. Hence, on a global basis, the drag to equity index performance has come from the tech sector, where the total return on the Datastream technology index was -7.4 per cent per annum in the decade to the end of 2009. By contrast, according to Datastream, the global mining sector gave a total return of 19.6 per cent per annum. This is a near mirror image of the position in the 1990s. Whatever the next decade holds, identifying the characteristics of likely winners and losers is likely to continue to have a significant bearing on the ability to generate above market returns.

Moreover, the world is not static. There are often significant changes that can transform sector and market performance within a period. Highlighting this possibility is the divergent performance between US homebuilders and the Chinese "A" share index over the last 10 years. Over the whole period, the total returns on both indices are similar for a dollar investor: 10.6 per cent per annum

on the US home building index and nine per cent per annum on the China "A" share index. Yet, at the end of 2005, the composite of US home builder equities had risen at 41 per cent in the six years since the Millennium, while the "A" share index had fallen three per cent per annum from its level at the start of 2000, according to Datastream. It was perhaps no coincidence that the turning point for the performance of both areas came when the Chinese de-pegged the renminbi from the US dollar, as at the margin this move diverted capital that had been recycled from China back to the US as a means to prevent the exchange rate from moving toward funds remaining in China instead.

Looking forward, despite the headwinds to global growth prospects presented by the high level of indebtedness in the developed world (something that has increased, not decreased, during the credit crunch) and the threat from increasingly populist policy measures undertaken in the developed world, there are a number of positives for the near- to medium-term prospects for equity returns. Not least is valuation, particularly relative to government bonds. The dividend yield on the MSCI world index at the end of 2009 was 2.4 per cent, not far below the 2.8 per cent yield on the JP Morgan global government bond index. The ratio of the two yields was 0.6 (compared to 0.85 at the turn of the year) for most of the 2003-2007 period. Even more extreme is the favourable comparison with real bond yields. Hence, where both the dividend yield on the MSCI index and the 10-year yield on inflation-protected Treasury bonds remained close to two per cent through the 2003-2007 period, the real yield on these Treasury bonds is now 1.5 per cent. There is little expectation for dividend growth priced into equities.

That the problems generated in the last cycle have been fixed by further opening credit channels and by slashing the running costs of the existing stock of debt suggests

that the fragilities that contributed to the downturn remain. Despite the moves to tighten monetary policy from extremely loose settings in countries such as Australia and more recently China that have been less affected by the effects of the credit crisis, it is clear that these will continue to be tentative as concerns remain about the sustainability of the rebound and the impact on currencies that a significant increase in local interest rates would cause. It is likely that conditions are a long way from those that would cause the Fed to increase interest rates (recently, the New York Federal Reserve president William Dudley suggested that the "extended period" referred to in the Fed policy statement indicated that interest rates were likely to remain unchanged for at least six months). In the early 1990s, as the US struggled to recover in the aftermath of the savings and loans crisis, the Fed held rates at three per cent throughout 1992 and 1993, despite non-farm payroll employment increasing by four million over the two-year period. In the end, bond investors were astounded when the Fed increased rates in February 1994. In Dudley's words, "job number one" for the Fed is generating employment. Despite the improvement from the lows, however, there is little sign of job creation in the US. As such, the supportive policy backdrop is likely to remain.

Changes over the coming decade are likely to be as extreme and as challenging to forecast as those in the last 10 years. Arguably, the first challenge for investors is to accurately predict when and by how much the Fed will raise interest rates, as this could well cause some significant changes in financial markets. As yet, data suggest that this policy change remains a distant prospect, implying little reason to expect significant adjustment in current trends.

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