Rethinking
'Equities for the Long Run'

Thanks to great work by men such as Alfred Cowles in the 1930s and more latterly Professor Robert Shiller, financial historians have easy access to many decades of stock returns to dissect and analyse. Perhaps the most important information the data contains is that, over the long run, equities have significantly outperformed bonds. For example, Shiller's data calculates that the real total return (i.e. post the effects of inflation) on US equities between 1871 and 2010 was around 6.5% per annum – a far higher return than the 2% p.a. real return on bonds. While bonds have outperformed equities over certain sub-periods (meaning decades), this can explained by the observation that these were preceded by eras of highly valued equity markets (for example the Nifty Fifty and TMT stock market bubbles). Thus there have been long periods when stocks have substantially outperformed bonds, typically from a point where stocks have started out cheaply (post 1982, for example). The long run data seems to present us with a pretty solid open-and-closed case in favour of equities and provides the background to Jeremy Siegel's book *Stocks for the Long Run*, first published in 1994.

That equities have outperformed seems quite logical. The argument goes as follows. Stocks are riskier than bonds – their prices are more volatile, their dividends are unpredictable and shareholders are bottom of a company's capital structure. As investors are risk averse they will demand a higher return when they buy stocks. Make sense? Here's what Howard Marks of Oaktree Capital had to say on the subject in his January 2006 memo entitled *Risk*:

Especially in good times, far too many people can be overheard saying, "Riskier investments provide higher returns. If you want to make more money, the answer is to take more risk." But riskier investments absolutely cannot be counted on to deliver higher returns. Why not? It's simple: if riskier investments ***reliably produced*** *higher returns, they wouldn't be riskier!* (Emphasis added).

Rather, riskier assets have to offer the **prospect** of higher returns.

Certainly, riskier assets will be rewarded with superior returns if things go according to plan. Naturally one cannot expect everything to go well, investment after investment, cycle after cycle. Inevitably there will be setbacks, imposed by the general economic backdrop, or by competition, or just by sheer bad luck. **The prospect of higher returns in good times is compensation for the lower returns in bad times.** The very nub of what this article tries to address is what the scale of compensation *ex. post* should be; indeed we wonder should there be any!

It would seem to us illogical to assume that equities should return more than bonds over the long run. If it were true, investors would seek out the extra return on offer. Thus capital

would shift out of bonds into equities, lowering bond prices and hence lifting their prospective returns, while at the same time reducing the prospective returns for equities. Of course, starting valuations matter, but over the very long run the impact of de- or re-ratings on average annual returns is much reduced. At least in a theoretical sense, the **expected return of all asset classes should be equal**.

One possible rationale for a higher expected return is that riskier assets tend to be more volatile, causing investors to sell at inopportune times – in other words, investors need to be compensated for their own psychological weaknesses. And a superficial look at the *actual* returns to equity investors bears this out. According to a study by US market research firm Dalbar, over the 20 years ending 2010 the average equity fund investor earned a return of around 4% per annum, compared to the 9% achieved by the S&P500 over the same period. This is a stunning statistic. Partly this result is down to fund manager underperformance and fees. It is also partly due investors' inability to remain fully invested through the ups and downs of the market (investors try to 'time the market' or worse they become forced sellers when prices are low). So while it might appear that a free lunch is available by investing in equities, perhaps the truth is that the average investor either doesn't have the temperament or the time horizon to capitalise on it, leaving outsized returns for just the few.

The reality is that the same fate befalls bond investors. The less-quoted statistic from the same Dalbar study reports that your average bond investor captured a return of just 1% p.a. over the 20 years to 2010 versus the near 7% p.a. return from the Barclay Aggregate Bond Index over the same period. Dalbar has been tracking returns for 17 years and the results are the same back over that time. In summary, there's no evidence that the 'psychological tax' on higher-risk equity funds is any greater than on lower-risk bond funds.

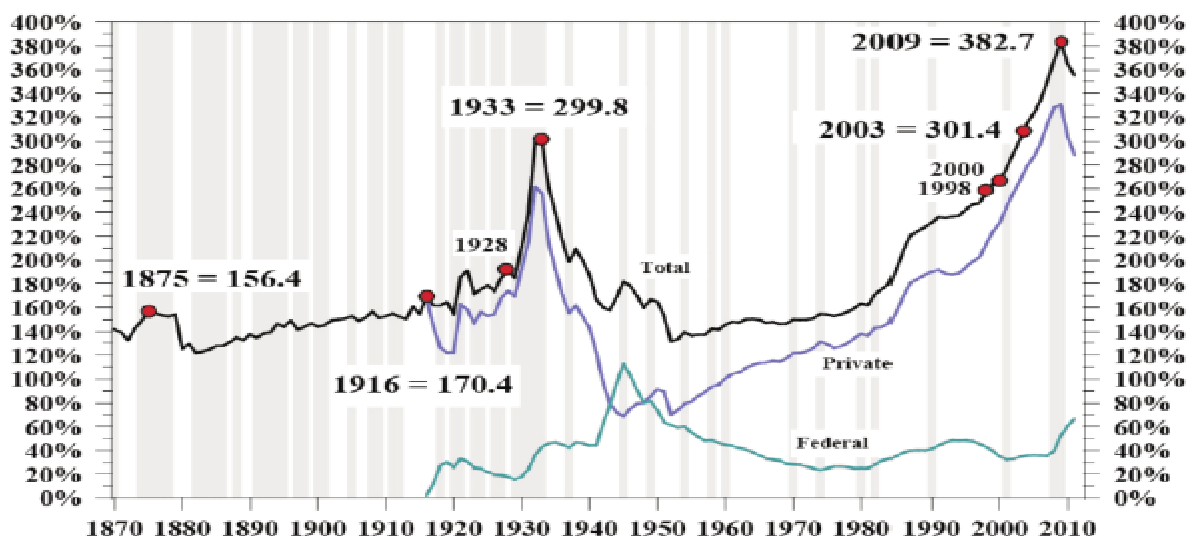
More importantly, applying Nassim Taleb's theory of alternative histories, the results of the last 140 years are based on just one of the many possible outcomes that could have occurred but didn't. How different might things have looked had the southern Confederates won in their fight to secede from the Union, which could have created a long lasting military rivalry and an impediment to US prosperity? What if Hitler had won? Or Cuba had fired the missile? Or the US dollar had lost its reserve currency status when it decoupled from gold in 1971? Clearly the last one hundred and forty years has had its setbacks and disruptions, but who knows what the alternative outcomes could have brought. In that context, one and a half centuries is far too short a period to get a good handle on the how equities might perform across the many different branches of the outcome tree.

Furthermore, we must be aware that mankind's progress is unlikely a smooth, linear path. According to independent US think-tank The Cato Institute, *"By any conceivable measure, the 20th century has truly been the greatest century of human progress in history."* Now optimists among you might take great heart from this, assured that our rate of progress will be maintained or even accelerate from here. It appears that Buffett is one such optimist, regularly talking up America's prospects (*"There's no way you can bet against America and win"*).

Of course, due to the fixed nature of non-equity liabilities, the benefits of better-than-

expected outcomes for businesses accrue to shareholders. Those with a more conservative slant can convincingly argue that it was the last century's surprisingly strong economic progress – an outperformance versus what was *a priori* expected – that led to equities' outsized historic returns. Remember though, equities operate on a two-way street. Just as they benefit on the upside, they suffer commensurately on the downside. In that context, can we really be counting on a repeat performance by equities in the decades and centuries ahead?

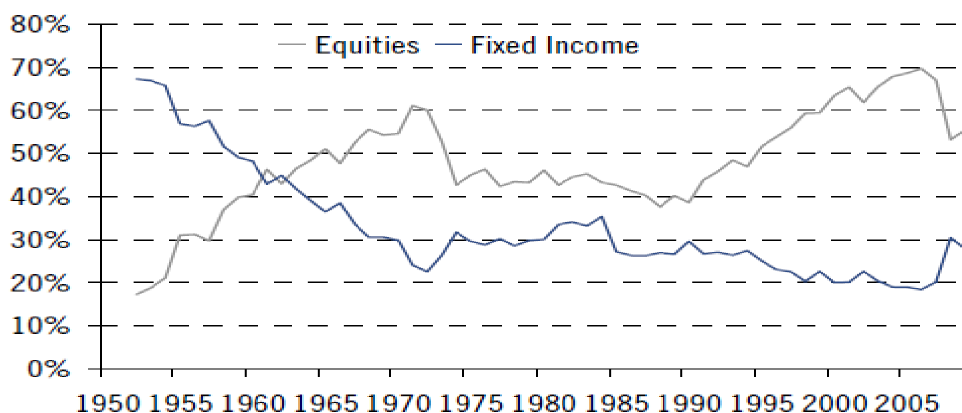
On that note, it's worthwhile considering the role that increased debt levels have played in boosting economic growth globally. As an example, see below the chart of US private and public debt expressed as a percentage of GDP. Between 1870 and 1980 the ratio ranged between 120% and 200%, save for the period of the Great Depression (when a sharp fall in GDP was the primary cause of the increase). Since the 1980s, debt levels have ballooned to over 350% of GDP – this is before taking into account the off-balance sheet entitlement liabilities and guarantees which would, it is estimated, bring the ratio to more than 500%. What is more, the off-balance sheet items are a post-WW2 phenomenon and have been growing exponentially i.e. adjusted debt to GDP would look similar to the chart below up to WW2, thereafter the gap would widen gradually, accelerating from the 1970s onwards. There's no doubt that increased debt has been additive to growth and stock returns over time, but this is a once-off effect. This is a road that will eventually run out of tarmac. It's worth pondering what economic growth and equity market returns would we have observed under stable leverage conditions. The answer is surely 'lower'.



The point of discussing alternative histories, historic economic progress and the role of increased leverage is this: equities' past outperformance versus bonds and other asset classes proves nothing. The 'narrative' that riskier assets should have higher returns over the long run sits well with the historic experience. However, the existence of such a return premium – post the effects of risk – appears to defy the laws of competitive forces.

Nevertheless, the mantra has had major consequences for how investors' capital is being invested. The chart below, taken from a 2010 Citigroup research report (*Global Equity Strategist: The End Of A Cult, September 2010*), shows how US pension funds (a proxy for long term investors) have allocated to bonds and equities over the last 60 years. In the early 1950s, with the Great Depression still relatively fresh in investors' minds, the allocation to bonds was roughly three times the allocation to equities. The post-World War II period has proven to be an especially rewarding time for equities. It must be suspected that this has encouraged investors to allocate a far higher proportion of assets to equities. Despite a rough past decade for equities, it would appear that investors are still in love with the asset class!

Figure 3. US Private Sect Pension Asset Wts[2] (%)



Source: Fed, Citi Investment Research

We broach this topic with guarded reserve. It is controversial and flies in the face of much of what we read in finance. We ask readers to consider this article as thinking-in-progress. One of the core aims at the Value Investment Institute is to develop investors' thinking, to constantly question commonly held beliefs and assumptions. At the very least this article does that. We hope readers will vigorously contribute to both sides of this debate.

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