

## What's the future for investment returns?

July 2008

**Over the last few months stockmarkets around the world have suffered increased volatility, with the UK FTSE All Share (ex Investment Trusts) falling over 21% (at the time of writing, 3 July 2008) from its high in 2007.**

It is not surprising, therefore, to hear comments such as 'Markets are uncertain' and journalists and other 'experts' questioning whether capitalism as we know it will cease. Markets are driven by news and such news is random.

Notwithstanding the current problems relating to the credit crunch, stock markets are always uncertain, otherwise there would be no return premium for owning equities and we would all own government bonds or cash. In addition, while seeing the value of one's capital fall and rise wildly can be emotionally uncomfortable in the short term, inflation is arguably the greater threat to long-term financial security and freedom of choice.

Short term forecasting of what will happen to different asset classes is a fool's errand and is of no benefit to the smart investor. Whenever annual investment returns from equities depart materially from the long term norm this is not usually due to the economics of investing - the earnings growth and dividend yield of companies. Earnings growth has been positive in every moving decade since the 1930s and dividends are always a bonus, not a given. Stockmarket returns are volatile because of the emotions of investors and their willingness to pay a higher or lower multiple for earnings from companies. The price/earnings ratio, as it is known, reflects the swings in investor emotions ranging from greed (high P/Es) to hope (moderate P/Es) to fear (very low P/Es).

Because the bulk of returns from stock markets are based on earnings and dividends, the market has a positive sloping return expectation and in broad terms there is a 3 out of 4 chance of returns being positive in any given year. Therefore forecasting long-term returns, rather than short term investor sentiment, is actually a much more achievable task. Benjamin Graham, the eminent American investor once said: "in the short run the stock market is a *voting* machine... (but) in the long run it is a *weighing* machine."

## Investment return and speculative returns

Renowned economist John Maynard-Keynes divided stock market returns into 1) Investment Return – being the dividend yield on equities plus the subsequent earnings growth; and 2) Speculative Return, being the impact of changing P/E ratios on equity prices. Putting the two together gives us 3) Total Return on equities.


So if we assume a dividend yield of 3% and earnings growth of 4.5% we get an expected return of 7.5% for the next 10 years. Let's assume, say, that the P/E rises from 11 to 15, representing an increase of 36%. Spread over a decade it would add over 3.6% per annum to the return. If, say, the P/E fell from 11 to 10, a decrease of 9%, then the return over the following decade would be just under 0.90% per annum less.

Over the last 100 years the average total return on equities of 10.1% was almost the same as investment returns from dividends and earnings growth of 9.90%. All that speculation only generated an additional 0.20% annual return. But speculation does create many short term variations such as in the technology boom of the late 1990s or the melt down of the early 1970s.

## Future return expectations

So how can we use this approach to predict future returns from equities over, say, the next 10 years or more? Nominal earnings growth has historically averaged about 7% per annum depending on what time period and market one looks at. If one assumes it will run parallel to the growth rate of the economy then over the next 10 years there is no reason not to assume that earnings growth will be in the region of 4 – 5% per annum, so let us assume a rate of 4.0% per annum i.e. 43% lower than the long term average.

Dividends are slightly different and from a high of 6.80% in the late 1970s, when they contributed almost 70% of the total return, they fell to 2.2% by the start of this decade, a reduction of almost 70%. The yield on the UK All Share Index is now approximately 4.30%, as a result of the fall in share values and rising profits over the past decade, so when added to our assumed earnings growth this represents over 50% of the expected return.



The P/E ratio rose throughout the 1980s and 1990s from a low of 10 (fear) to a high of 25 (greed). There then followed a reduction to the current ratio of just under 11. Looking forward, which is always the tricky part, it is highly likely that the P/E will ease downward rather than surge upward, so our best guess is that we will see the P/E ratio fall from the current 11 to, say, 10, which is below the historic long term average of 13. This would mean the P/E ratio would fall 9%, equivalent to a reduction in the expected investment return over 10 years of 0.90% per annum. If you have your own ideas on the direction of P/Es then do your own calculations to determine your expected future return using the same formula.

We think it is safe to assume that over the next decade or so we are unlikely to experience the double digit returns of the 1980s and 1990s. A return in the range of 6-8% per annum seems more reasonable but it will probably come with more volatility. So the only certainty about the future is that it is uncertain. No asset class offers a hiding place when the risks seem highest and the world seems full of doom and gloom. The case for holding a diversified, multi asset class, liquid portfolio has never been stronger than it is now. In addition, the benefits of re-balancing such a portfolio whenever its constituent parts diverge significantly from the model allocation become even more obvious with increased market volatility such as we have today.

### **Emotion versus logic**

One issue that impacts on individual investors when financial and economic news becomes negative and stockmarkets experience downturns is committing new funds to a long term investment portfolio. Most portfolios will, to a greater or lesser extent, include some allocation to growth assets such as equities or property, in the expectation that those assets should, over the long term (twenty five years or more), deliver better real returns than other, more defensive, assets. Certainly there is a high probability that they will deliver the expected positive returns over twenty five years or more, but when those asset classes are fluctuating wildly and trending downwards in value, investors more often than not are unwilling to commit capital. Whilst totally understandable from an emotional perspective (who wants to buy something today when it might be cheaper tomorrow?) this approach is totally illogical in the long term. Buying an asset class with an expected positive long term return when it has fallen in value means that it has a higher expected return and a **higher probability** of delivering that expected return compared with buying it when it has risen or is at its peak.



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No one can predict markets. As we have illustrated earlier, speculation on what will happen to values in the short term adds virtually nothing to the long term return on equities and if the expectation is for an asset class to deliver positive returns over the long term it would be better to invest funds when the rest of the world doesn't want to. Furthermore, a fully diversified, multi asset class portfolio will include several other low cost indexed asset classes such as index linked gilts, short dated bonds, commodities and global real estate, which have different characteristics to equities and as such the daily movements of equity markets have even less of a bearing on when cash is committed.

There are returns from capitalism that are there for the taking but one needs to focus on the long term trends, not the short term noise. Or put another way, don't measure the distance between your home and your office with a 6 inch ruler!

Contacts	Telephone	Email
Jason Butler	07973 951107	<a href="mailto:jasonbutler@bloomsburyfp.co.uk">jasonbutler@bloomsburyfp.co.uk</a>
Carolyn Gowen	07775 712969	<a href="mailto:carolyng@bloomsburyfp.co.uk">carolyng@bloomsburyfp.co.uk</a>
Robert Lockie	07951 725880	<a href="mailto:robertl@bloomsburyfp.co.uk">robertl@bloomsburyfp.co.uk</a>

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