The Red House

WHEN IS THE BEST TIME TO INVEST IN EQUITIES?

At the time of writing this note, we are going through one of the most remarkable periods in financial markets that most of us can remember. I would not wish to recycle all of the mass of opinion, commentary and data that has been so prolific over the last few weeks but thought some comment on the TRH philosophy we use in our client advice process and in building and managing portfolios might be useful.

Market Timing

At TRH, we believe there is one main reason to invest in equities. That is when the long term return from this asset class is required to deliver the investment growth necessary to meet your objectives. We do not believe that it is possible to “time” markets. A couple of pointers from the past highlight the dangers of trying to time equity markets.

- If you had been invested in the FTSE All Share between 31 March 1993 and 31 March 2008, some 3914 days, you would have received a return of 8.49% per annum; however if you had missed the best 40 days out of those 3914 days, your returns would, in fact, have been negative at -0.54% per annum. (*Source: Fidelity*)

- Sadly I am old enough to remember a time when markets were as bad as they are today – perhaps worse. In 1973 the FTSE All Share index declined by 28.63% followed by a further drop of 51.62% in 1974. In 1975 the Index then recovered by a record one year return of 151.41%. Indeed in January 1975 the FTSE All Share posted weekly gains of 9.4%, 9.7%, 23.9% and 9.4%. I would not want to miss the upturn this time when it comes, as it surely will, unless we are seeing the end of capitalism and free democratic markets.

Experience has shown that attempting to time markets is more likely to damage the long term returns on your portfolio rather than delivering extra value.

Your Personal Rate of Return

For most of our clients, we have built a detailed long term cash flow forecast that underpins the financial planning we do for you, including the recommended investment portfolio. This forecast includes assumptions on the long term anticipated returns from all of your assets including the investment portfolios. These returns are combined to determine the personal rate of return (PRR) required on your portfolio to deliver your goals.

TRH makes conservative assumptions on the returns for different asset classes. Our experience over the past 12 months in building clients’ forecasts is that the PRRs are coming out at between 5.5% to 6.5% per annum. These are nominal returns. This translates to real returns of between 2.5% and 3.5% per annum, taking into account our usual inflation assumption of 3% per annum. The portfolio is therefore required to deliver this level of annual return over the financial planning period, which we usually run until age 100. In other words, this is long term portfolio planning! Most importantly, we always ensure that there are sufficient liquid assets available for shorter term needs - up to 5 years at least.

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Long Term Equity Returns

Our long term confidence in equity markets is demonstrated by the table below. This compares real (after inflation) returns for the main asset classes of equities, bonds and cash over different holding periods between 1899 and 2007. The first column shows that over holding periods of 2 years, equities outperformed cash in 72 out of 108 years. Thus the sample based probability of equity outperformance is 67%. Extending the holding period to 10 years, equities outperform cash for 92 out of 99 periods and the probability of equity outperformance rises to 93%. Further research has shown that over a 20 year period the minimum return from equities is always greater than cash or gilts since 1899.

Equity performance						
	Number of consecutive years					
	2	**3**	**4**	**5**	**10**	**18**
Outperform cash	72	75	78	78	92	90
Underperform cash	35	31	27	26	7	1
Total number of years	107	106	105	104	99	91
Probability of Equity Outperformance	67%	71%	74%	75%	93%	99%
Outperform Gilts	75	81	82	79	81	83
Underperform Gilts	32	25	23	25	18	8
Total number of years	107	106	105	104	99	91
Probability of Equity Outperformance	70%	76%	78%	76%	82%	91%

Source: Barclays Capital

The following table shows the real returns from the major asset classes for consecutive 10 year intervals. As you can see, there are only two periods (1927-1937 and 1997-2007), where equities have underperformed gilts. In this last decade, equities lost the “title” of best performing asset when the 2007 weak performance dragged the 10 year annualised average lower. The 10 year equity return to December 2007 is the worst since the 1967-77 decade which covered the first OPEC shock, the three day week and the initial stage of stagflation.

Real investment returns (%p.a)					
	Equities		**Gilts**	**Index-linked**	**Cash**
1907-17	-3.8		-7.2		-3.8
1917-27	9.1		6.1		5.2
1927-37	6.1		7.3		2.6
1937-47	4.0		1.3		-1.8
1947-57	2.3		-6.2		-2.5
1957-67	11.4		0.8		2.1
1967-77	-0.2		-3.2		-2.5
1977-87	12.0		4.5		3.4
1987-97	10.4		6.9	5.0	4.6
1997-2007	3.1		3.3	3.7	2.5

Source: Barclays Capital

It should be remembered that these returns are in decades when the yearly real returns have swung from -62.5% (1974) to +89.2% (1975) and a number of consecutive periods of negative returns (1910 to 1917, 1960 to 1962 and 2000 to 2003). Volatility is a characteristic of equity investment and hence we only recommend equities on money that is invested over a long term.

The above table also shows that there were only two decades, 1907 to 1917 and 1967 to 1977 where the real rates from equities significantly undershot the PRRs most of our clients require. The FTSE All Share real return in the 10 years to September 2008 is 1.05% per annum, the third worst decade since 1895.
(Source: Dimensional Returns Programme October 2008).

It will certainly be a remarkable outturn if the next 10 years also rank amongst the poorest performing decades, but we would always remind clients that we cannot predict future returns. Our investment philosophy is based on the belief that in the long term the risk of investing in equities will be rewarded by a return above the other major asset classes.
(*All the above data and tables were taken from the Barclays Equity Gilt Study 2008*.)

Of course, none of TRH's clients have 100% exposure to the UK equity market over the totality of their portfolio. We build diversified portfolios using low risk short dated bonds and cash alongside the equities funds that invest in all the major world markets. The bond/cash exposure has the effect of diluting the volatility of the equity holdings.

How does this affect you?

The current short term negative performance is only of significance if it continues over the longer term. We would start to get concerned if it looks like the required PRRs start to slip over the next 10 years. We will review this with you as part of your annual planning programme.

We believe the best approach to the current volatile and uncertain climate is to maintain the equity exposure we have agreed with you to deliver your PRR. Indeed, there could be an argument for rebalancing your portfolio back to the original equity/bond allocation by switching some of the bond fund holdings into equities. We will look at rebalancing at your annual review meeting.

So, in conclusion, the best time to buy equities is when you require the long term premium that this asset class provides over cash and bonds. It is certainly not the time to sell long term funds when the markets are low; indeed there are logical long term reasons for continuing to build equity portfolios through markets such as these.

We do appreciate that the continual flow of negative economic news can cause real worry for our clients. We hope this note will bring reassurance that we understand in detail your financial situation and the long term plans we have built are still working in these volatile times. We have been in communication with all of our clients holding equity portfolios over the past few weeks. Please do call us, at any time, if you have any concerns over the current market volatility and how it might affect your financial planning.

Gareth Marr
The Red House
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