Abandoning equities would be a bad move

» Data back to nineteenth century make strong case for the asset class

Olivier Zucker

The 'death of equities' has resurfaced once again as a popular topic in the financial media, and the chief executive officer of a successful investment firm recently queried whether equities have any future at all in private client portfolios.

The frustration is understandable. Since the peak of the dotcom bubble in 2000, global equities have returned just 0.9% a year in sterling terms (as measured by the MSCI World All Country TR Index). The annualised returns over the past five and ten years have also been disappointing, at 2.8% and 5.1% respectively.

This falls well short of the long-term performance of global equity markets, which has been nearly 9% a year when dividends are reinvested. So are equities dead? In our view, they are not, and it would be foolish to abandon the asset class: equities will still be needed to provide the bulk of future investment performance.

Little help outside bonds

The recent underperformance of equities has created a major headache for investment managers and their clients. It has opened up a big gap between actual and expected returns, yet volatility is as high as it has always been.

The strong performance of bonds has provided some compensation, with UK Gilts returning 6.6% annually over the past ten years. Yet bonds have often been a relatively small part of private investors' portfolios, particularly for those focused on capital growth.

So-called alternative investments have not helped much, except to make portfolios more complicated to manage, along with more management fees. Either the asset class did not perform as had been expected (as in the case of hedge funds) or the overall correlation to equities became so strong the diversification effect disappeared (as in the case of commodities and property).

History's guide

When addressing the question as to whether equities are dead, taking the long view is useful. The returns from equity markets have tended to revert towards their mean level over time. In the chart (see below), we use data from the US market dating back to 1871. This shows annualised returns for the S&P 500 over five-year rolling periods, adjusted for dividend reinvestment.

Over this horizon, the index achieved a return of 8.8% annualised, a number that is pretty stable over the long term.

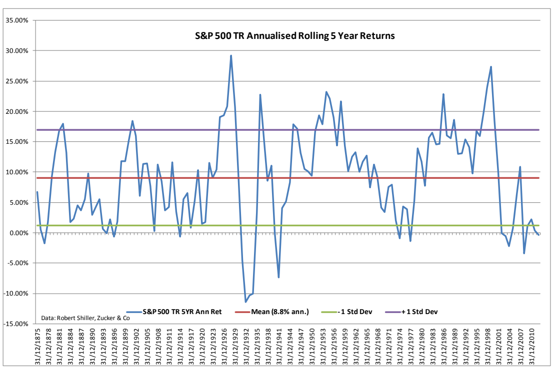
Assuming mean reversion still holds, the current picture is fairly encouraging. The latest reading shows the return over the past five years was -0.82% annualised, a number that is below one standard deviation from the mean. Most performance improvements have started from a similar position, although it could still take another year or two for the trend to reverse, and another three to five years before the trend has returned to the long-term average.

Towards a new framework

For most of us, three to five more years of sub-par performance is a long time to wait, and we believe investors will need to be more proactive to achieve their required returns. Rather than give up on an asset class, they should instead abandon an outdated investment approach.

Many investment managers are still using a static framework based on strategic long-term asset allocation.

» ROLLING FIVE-YEAR RETURNS ON S&P 500 NEARING HISTORIC LOWS



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Yet in today's environment – where growth is low, debt levels are high and markets seem addicted to stimulus measures – we are unlikely to see the sustainable broad-based moves in equity markets these static models have been designed to capture.

Investors need to become much more nimble and flexible. The approach we have developed at Zucker & Co is dynamic and designed to harness the power of market momentum. We follow a disciplined and rules-based strategy that obliges us to reduce exposure to risky assets such as equities (and move into safer assets such as government bonds and cash) when equity momentum turns negative, and to reverse this when momentum turns positive again.

The beauty of this approach is our models are self-correcting and prevent us from investing against market trends. This leads to a portfolio which focuses more on avoiding losses and preserving capital during difficult times, rather than sticking to riskier assets in order to generate (theoretically) higher returns.

New diversification

Rather than focus on asset class exposure, investors should concentrate on identifying talented specialist managers, whose returns are not dependent on the broad upward drift of a market.

Simply allocating money to a wide range of asset class 'buckets' is no longer a recipe for good investment returns.

In the new world, we recommend diversification by talented managers, segmenting by ability and success. Manager selection is key, not asset allocation, and those managers with a proven track record of making money across the market cycle should form the bedrock of an investment portfolio. S