

staying on tra

July 2009

Recent times may have led investors to question the long-term value of equities. However, those remaining cautious could miss a compelling opportunity, says **Rupert Watson**.



Global equities fell by about 40% last year, one of the worst years ever. The old advice that 'equities outperform bonds' seemed misplaced at best. So should investors be on the sidelines or even re-assess the long-term attractiveness of equities?

We don't think so. In our view, the long-term attractiveness of equities remains unchanged and they still form a vital part of any portfolio. It's precisely because equities have performed so poorly in the recent past that they are so attractive now. And in the shorter run there are also plenty of reasons to be optimistic.

what does history tell us?

Over long time frames, equities have outperformed bonds and cash – a fact consistent with financial market theory, which says you get paid more over the long term for holding riskier assets. **Figure 1**, taken from the Barclays Equity Gilt study, shows that equities have outperformed gilts

over the last 50 years and over the last 109 years as well. More recently, however, equities have underperformed gilts, quite substantially in 2008. Gilts have generally outperformed cash.

what about the last 10 years?

The last 10 years have been close to the worst in the history of the UK equity market, a period which includes the Great Depression. **Figure 2** shows the rolling 10-year real and nominal returns for UK equities. The nominal return over the last 10 years has been 1.05%, only slightly better than the 1.02% in the 10 years to 1974.

so why equities now?

To understand why it's such a good time to increase exposure to equities, it's important to understand why the last 10 years have been so poor. There were two main reasons. First, equities were overpriced at the end of

the 1990s. The price/earnings ratio (P/E ratio) on the major stock indices reached an all-time high in the late 1990s, over twice the historic average. The price investors were paying to buy into the equity market was thus the highest it had ever been. Second, the financial crisis and subsequent global recession led to sharp falls in equity markets in 2008, as earnings, confidence and risk appetite nosedived.

From a multi-year perspective, now is a good time to be buying equities as they are cheap on a number of measures. US and UK equities are at their lowest P/E ratio in almost 20 years and lower than the long-term average. **Figure 3** shows the earnings yield divided by the 10-year bond yield – the so-called 'Fed model'. It shows that in the early part of this year equities were at their cheapest level ever versus bonds. Even after the recent equity rally and bond sell-off, equities remain very cheap. Against cash, equities are even cheaper. In their annual Equity Gilt Study 2009, Barclays estimated that equities should return on average 13% a year starting at the end of 2008, using a valuation model based on the P/E ratio and Tobin's Q.

short to medium term

The outlook for the next few quarters is also positive in our opinion. The weakness in 2008 was caused by the twin problems of

figure 1 – real investment returns by asset class (% per annum)

Last	2008	10 years	20 years	50 years	109 years*
Equities	-30.5	-1.5	4.6	5.7	4.9
Gilts	11.7	2.4	5.5	2.3	1.2
Corporate Bonds	-11.0	1.2	–	–	–
Index-Linked	-2.1	1.9	3.9	–	–
Cash	4.2	2.4	3.5	2.0	1.0

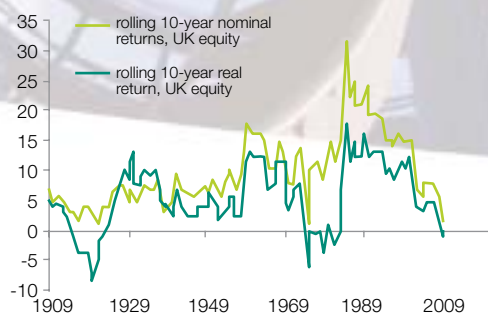
Note: *Entire example. Source Barclays Capital.

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“ It’s precisely because equities have performed so poorly in the recent past that they are so attractive now. ”

figure 2

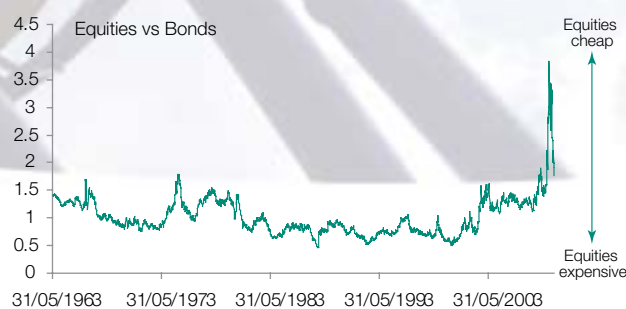
– rolling 10-year real and nominal returns for UK equities



Source: CRSP Barclays Capital.

figure 3

– earnings yield divided by the 10-year bond yield



Source: Bloomberg with Skandia calculations.

the banking crisis and the associated economic crisis. Both of these problems are on their way to being resolved. On the banking side, significant equity injections by the public and private sectors have materially improved banks’ capital positions. And government guarantees and other measures to improve the liquidity positions of banks have also helped. As a result there are a number of signs that the problems in the banking system are being resolved. First, banking and financial equities have rallied, with the S&P 500 financials index doubling over the last few months, while a number of US banks have already repaid funds to the Government. Credit spreads have tightened significantly, while the Libor/OIS spread (a measure of banking stress) is back to its lowest level since early 2008.

On the economic front, most data is pointing to recovery and a move out of recession this summer. Global Purchasing Manager Indices have risen. Some of the developing world, led by China, have already pulled out of recession. In the developed world the recovery is a few months behind, but leading indicators suggest that many countries (including the US, UK and Japan) will pull out of recession this quarter. Last year, the synchronised nature of the global downturn hampered

growth, while this year the synchronised nature of the recovery should help.

Inflation is likely to stay low, especially at the core level and notwithstanding some upward pressure from commodity prices. This is because of the large amount of spare capacity in both labour and product markets and should enable central banks to keep interest rates low for several years to come, supporting ongoing economic growth.

outlook

We expect most risk assets to perform well. In particular, we are overweight in equities, which we expect to outperform bonds and especially cash. Within equity markets we prefer Asian equity markets, where economic recovery and financial market healing is most advanced. Eurozone equities are our least favoured market, because of ongoing economic weakness and the weak policy response.

Within bond portfolios we remain overweight in corporate bonds, both investment grade and high yield, while underweight in government bonds and cash. Despite a significant rally over the past few months corporate spreads remain very wide, but could rally significantly over the next few quarters as the economy recovers. We

are also moderately optimistic on Emerging Market debt which should be supported by rising commodity prices and economic growth.

But isn’t there a consensus about recovery? Yes and no. Yes, there are fewer people expecting meltdown and most now expect economic and financial market recovery. But no, portfolios are not yet positioned for recovery. Back in the late 1990s, when valuations were at their highest, the financial press screamed ‘buy’. Over the last six months they’ve been urging caution. That’s the wrong way round in our view.

Importantly, trying to time the entry to equity markets right now is a high-risk game and likely to result in your clients missing out on important gains. Asset allocation remains fundamental to portfolio planning and while equity funds in isolation may be viewed as too risky for many investors, complete avoidance could mean missing out on a significant upturn in growth. ●

For more information on the categories of funds available through Skandia Investment Group, turn to page 28.

*Rupert is a member of the Skandia Global Asset Allocation committee (GAAC). The SIG GAAC meets regularly to formulate views on the outlook for the world’s key asset classes, markets, sectors and currencies.

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