

Equity markets in perspective: making sense of a lost decade

To the point

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For many equity investors, the first 10 years of the 21st century amount to a lost decade. Effectively bookended by two bear markets, the period has been a punishing one for those who put their faith in developed market stocks. US and global equities are down 17% and 12% respectively from where they were 10 years ago ¹.

Faced with such an outcome, investors can be forgiven for questioning the merits of stock investing.

History suggests, however, that periodic instability is the price of long-term success. While the bear markets of the past were traumatic affairs at the time, they now appear as surmountable setbacks in what has been an extremely positive long-term trend for stocks.

For long-term investors whose desire to beat inflation is matched by a high tolerance for volatility, and for pension funds that require real annualised returns in the mid- to high single-digits to meet their liabilities, stocks remain uniquely capable of delivering strong capital growth alongside rising income streams.

Bounce typically follows slump

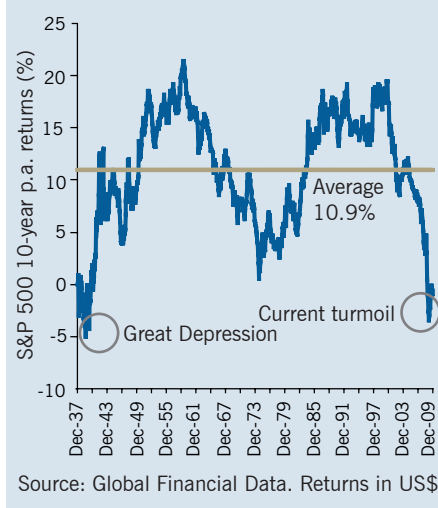
Stocks have proved resilient to the economic, social and political upheaval of the last 100 years. During the first half of the 20th century US equities delivered an annualised real return of 5.25% — robust gains in a period that witnessed two world wars, the Great Depression, and the start of the Cold War. The subsequent 50 years produced an annualised real return of 9.0% ².

Such gains can of course come at a cost that is too high for some investors. Many may balk at both the length of the investment horizon that is required and the volatility that can be expected along the way. Even so, there have been very few instances in which 10-year returns have been worse than those recently seen.

Indeed, those 10-year periods ending in 1937, 1938 and 1939 — years that encompassed much of the Great Depression — were the only other negative decades in history.

What is particularly encouraging is how stocks behave in the years following decades with poor returns. As Figure 1 shows, sharp declines are typically followed by years of healthy returns. Those invested in the US stock market in the mid-1930s, for instance, experienced a secular bull market lasting well over 20 years, the first 10 years of which delivered an annualised return of about 9%.

FIGURE 1: 10-year returns for US stocks last reached negative levels during the Great Depression



Consistently positive returns against bonds and cash

While the long-term returns for stocks are compelling on an absolute basis, they are also favourable when compared to those of other asset classes. Figure 2 shows how favourably cumulative returns for US stocks compare to those for bonds and cash.

This trend is especially relevant for investors with the longest investment horizons, such as pension funds. Many pension funds are turning to bonds

in the belief that the risk profile of such assets makes for a more effective way of meeting their liabilities. But because pension fund liabilities are dynamic and reflect, among other things, salary inflation and changes in mortality rates, fixed-income securities can prove to be inadequate hedging tools.

History suggests that the total returns stocks generate offer pension funds an extremely effective way of guarding against those factors that influence the size of future liabilities. Over the long-term equities also offer pension providers the most effective way of removing funding deficits, reducing the need to make up for any shortfalls with additional contributions.

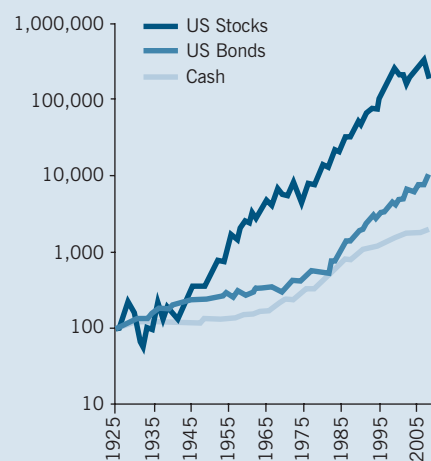
Economic backdrop encouraging; valuations compelling

While past performance is no guarantee of future investment success, the backdrop for equities appears especially positive.

To get a clearer sense of the market's short-term prospects, it is instructive to compare the economic and credit conditions businesses face today with those that prevailed during the Great Depression, the last time 10-year stock returns dipped into negative territory.

Then, as now, governments and central banks acted to prevent a collapse of the financial system. But in contrast to the laboured policymaking that took place in the 1930s, the measures implemented during this banking crisis have been swift, broad and globally coordinated, providing an altogether stronger platform for economic recovery. Many countries, for instance, put in place large economy-boosting programmes within a few months of the onset of recession. Interest rates were rapidly slashed to near zero in many parts of the developed world while governments acted quickly to protect systemically important

FIGURE 2: Total return for US stocks, bonds and cash with gross income re-invested — 1925–2009, log scale ³



Source: Barclays Capital

banks and facilitate the speedy recapitalisation of the financial system. Emerging markets also played a crucial role in underpinning world growth, having entered and exited the recession in far better shape than their developed counterparts.

These improved economic conditions coincide with appealing valuations. By some measures, equities are trading below their historic norms — a shift that to some extent is a mirror image of the unprecedented overvaluation that occurred during the 1990s.

Indeed, when assessing valuations, it is worth noting that the point-to-point measurement of this decade's returns starts in 1999, the pinnacle of an exceptionally strong bull run that culminated in the highest valuations in the stock market's history.

By analysing the risk premiums investors have historically required to buy stocks, the overvaluation of the 1990s and the opportunities of the present become especially clear.

During the 1990s, the earnings yield ⁴ fell below the Treasury yield, suggesting investors were willing to accept very little compensation for the extra risk attached to stocks. Since 2007, however, that yield differential has swung violently in the opposite direction: the extra compensation for investing in stocks has now climbed to its highest level in over 30 years.

Just as investors were clearly paying too much to access corporate profits and net worth in the 1990s, they may now have a rare chance to gain relatively cheap access to the growth opportunities stocks offer.

Strong secular trends

Longer term, stocks should benefit from a number of robust secular trends — structural forces that will gather momentum even if economic growth falters. Among these are:

Social, economic and market reform across the developing world. Emerging markets will seek to further empower their citizens and strengthen their institutions, economies and markets. The resulting rise in per capita income across China, Russia, Brazil and India should boost global consumption.

Global savings and investment shifts.

With wealth rising across emerging economies, savers will turn to higher-yielding investments. This, along with the development of public and private pension provision in developing nations, will increase the capital available for investment in financial securities, boosting the growth of stock markets across the world.

Favourable demographic trends.

Populations are rising in many parts of developing Asia, fuelling both job growth demand for consumer goods, credit and improved infrastructure.

Rising life expectancy in areas of the developed world should boost the prospects of a number of industries, such as health care and leisure.

Increased infrastructure spending. The Asia-Pacific region will become an even bigger consumer of infrastructure-related raw materials, driving growth among commodity-related companies.

Infrastructure spending is also rising in areas of the developed world: the US' investment plans span roads, health care information technology, telecommunications and rail.

Fuel use shifts. With oil and gas production having largely outstripped new discoveries since the 1980s, and the exploration and extraction process for energy resources becoming more costly, demand for both traditional and alternative fuels can be expected to surge.

It is interesting that several of these trends originate in the developing world. It is probably no coincidence that emerging markets equities — while volatile — have had much stronger returns than developed market stocks over the last decade. Nevertheless, many of the beneficiaries of these secular trends will be companies based in the developed world.

Keeping faith in equities

Stocks have been held back by powerful forces — systemic strains that economies and capital markets have not experienced in more than 60 years. But history shows that economic deterioration does not last for long.

Human ingenuity has shown a remarkable capacity to solve the problems that threaten to stall economic progress. Investing in stocks means having a stake in a uniquely powerful creative force capable of delivering high real investment returns.

¹ US returns based on MSCI USA Index, global returns on MSCI World Index in local currency with net dividends reinvested

² Source: Credit Suisse

³ Equity returns based on common stocks trading on the New York, American and Nasdaq Stock Exchanges, excluding ADRs. Bond returns based on those delivered by the US Treasury whose maturity is closest to 20 years in each month

⁴ The inverse of the price earnings ratio: earnings per share divided by share price

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