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Weekly Report - March 2009

BONDS: WHY BOTHER?

It seems like every so often an article, academic paper or book is published that captures the nature and mood of the current investment scene and serves as a guide to investment strategy from that point in time. We have had "Triumph of the Optimists" from the trio of economists at the London Business School and "Dow 36000" by three US journalists, both of which pointed to the huge historic outperformance of shares over the long term. Investors have tended to embrace these revelations with both hands and, in the case of the articles above, pile into shares. But because historic performance tends to look best at times when prices are high the results of acting on the lessons learnt have frequently been disappointing. Ironies abound – about 20 years ago another high profile bit of research showed that small companies outperformed large companies. Investors duly bought small companies and the trend promptly reversed – probably because small companies were expensive at the time the analysis was done which of course is why they looked so good.

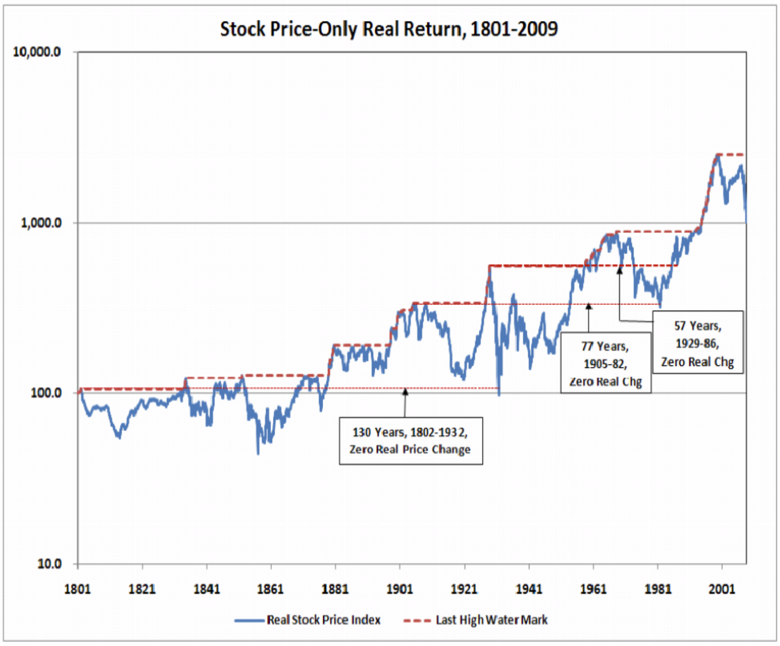
Last month, Robert Arnott, former editor of the US Financial Analysts Journal and investment manager of some $US31 billion at Research Affiliates, produced a report on US government bonds which is to be published in the May/June edition of the Journal of Indexes. The article, "Bonds: Why Bother", which Mr Arnott has kindly made available to Herald readers, looks like it will be one of the those historic pieces which defines the investing scene at the time. The article highlights the extraordinary fact that in the last 40 years, from February 1969 to February 2009, super safe 20 year US government bonds have generated a higher total return than the US stockmarket. This will be an unwelcome revelation to many as the conventional wisdom is that shares, because they are risky, should beat bonds if you can hang in there for 10 or at most 20 years. This purported outperformance of shares over bonds is known as the risk premium. It has been generally estimated at 5% pa and up until recently has been thought to be as reliable as a AAA rated bond. With the well documented demise of AAA maybe we should have known that the days were numbered for the risk premium as well. Mr Arnott's article is shocking stuff! The question for the panel however is whether, on the back of Mr Arnott's insight for analysis, we should be buying bonds or shares?

Let's look at the article in more detail. Long term historic trends are informative and bigger is better. Mr Arnott has data from 1802-2009. What is more the conclusions that Mr Arnott draws provide some good lessons in managing one's own investment portfolio. First up Mr Arnott backgrounds contemporary investment strategy and where bonds fit in. Most institutional investors use bonds in their tool kit for 2 key reasons; to diversify and to reduce risk. Additionally retail investors use bonds to produce a higher level of income than they could get in the bank. However bonds aren't usually the first port of call when one wants to grow one's wealth – stocks are favoured for growth and bonds are for widows and orphans. But Mr Arnott's analysis shows that if you bought 20 year US government bonds in February 1969, reinvested the income and rolled over into 20 year bonds each year, this strategy would have produced a higher return than could be achieved from owning the S&P 500 index of the largest US companies. That is a 40 year period when bonds have outperformed stocks. Most people retiring at 60 or so don't have any thing like a 40 year investment horizon unless they are very wealthy and are investing for their children and grandchildren. Nor is this result a statistical aberration - it has happened before and more than once.

According to Mr Arnott's paper US$1 invested in shares in 1802 would have risen to be worth approx. US$4 million over 207 years versus "just" US$27,000 if the US$1 had been invested in US government bonds. So over that period an investor who had opted for shares would be 150 times better off than someone else who had stuck to bonds. That is an impressive multiple but it works out to be a risk premium of just 2.5% pa. So that is the first revelation and one that Mr Arnott has flagged to Herald readers before, back in 2003. Shares can be expected to beat bonds but only by 2.5% pa. This is made up of 1.0% from real earnings and dividend growth and 1.5% from inflation. So if shares are only good for 2.5% pa over bonds, and if the average New Zealander with a managed investment portfolio is paying management fees to fund managers of 1-2% pa, other fees including turnover costs of at least 0.5% pa and a monitoring fee to a financial planner of another 1% pa, it seems like all they are destined to get from the average private banking equity – centric portfolio is the extra risk of shares with the additional risk premium going to their favourite private banker. That is lesson # 2…. But there is worse to come – 2.5% is a thin enough differential even without fees but its cost in terms of risk gives us, in Mr Arnott's words, "one heck of a ride".

So ladies and gentleman fasten your safety belts as we go back in time to 1802. The graph adjacent plots the performance of the US stockmarket without dividends and adjusted for inflation so that we can see how long it took for real shareprices to exceed our original buy-in price. If you had taken the plunge into equities in 1802 you had to wait for 32 years before your share portfolio got back to break even. Further more it took 75 years to convincingly exceed 1802's levels. But by 1929 your portfolio was up five-fold. Pride comes before a fall and we all know what happens next ….. the crash of 1929-1932 was so severe that share prices, expressed in real terms, briefly dipped below 1802 levels! This means that the U.S. stock market history exhibits a 130-year span in which real share prices were flat—albeit with a lot of swings along the way—*and so delivered only the dividend to the stock market investor*. The 20th century offers us a similar instance; "from the share price peak in 1905, we saw bull and bear markets aplenty, but the bear market of 1982 (and the accompanying stagflation binge) saw share prices *in real terms* fall below the levels first reached in 1905. A 77-year span with no price appreciation in U.S. stocks."

Figure 3. The Longest Spans Lacking Real Stock Price Appreciation, 1802–2008



That is enough bad news for one Saturday. Mr Arnott concludes on a more optimistic note warning that while much investment activity relies on false dogma the tools are there now or will be soon available to genuinely improve returns and diversification. He sees the imminent arrival of equal weighted, exchange-traded bond index funds as something that will address these needs but that is a story for another day.

For the record Mr Arnott picks that stocks will outperform bonds in the next 40 years and adds "a 3% yield on treasuries isn't that hard to beat given that stocks now yield more than that. Even a little growth in earnings and dividends can create a risk premium. Furthermore if our staggering new debt load triggers inflation as we monetize that debt bonds could cancel their bond yield with falling prices".