

Investment Insights

Equities – the end of the road or full steam ahead?

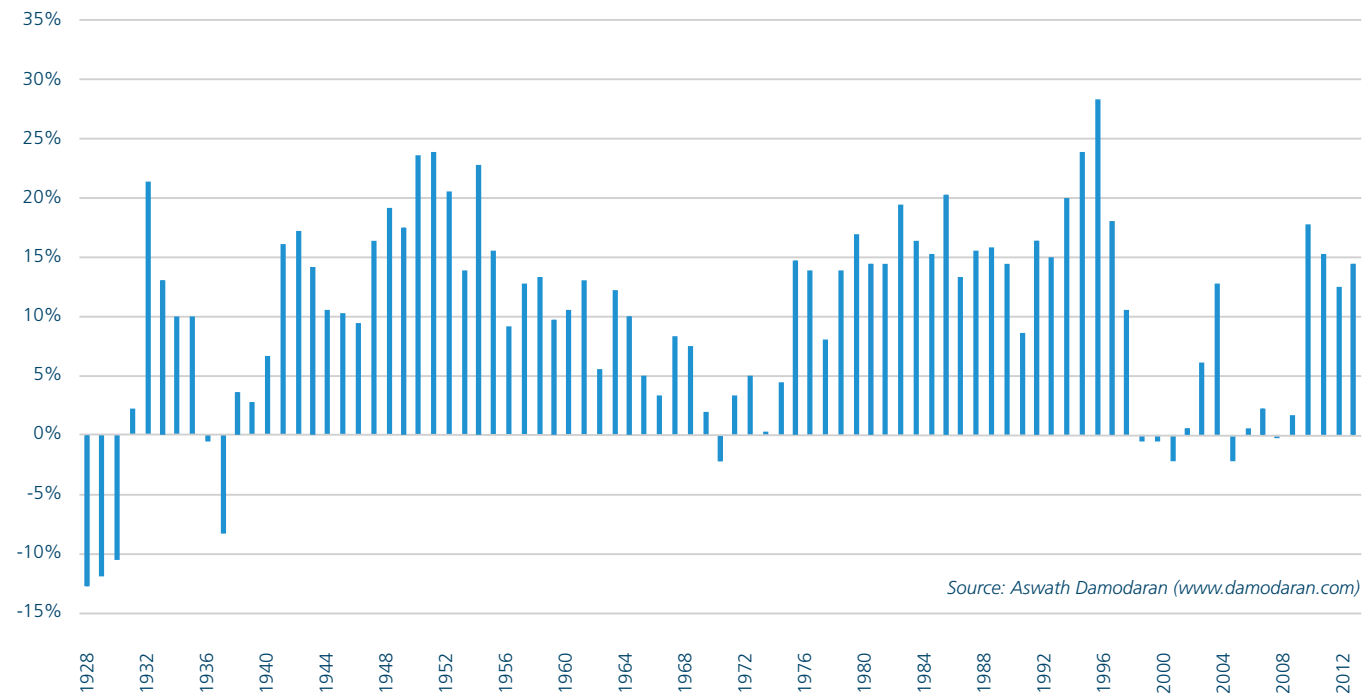
September 2017

Over the last five years, equity markets across the globe – but particularly in developed economies – have experienced strong growth, averaging around 13% per annum. This doesn't appear to be slowing down.

In many cases, the rallying equity markets have helped offset some of the rises in pension scheme deficits caused by the continued falls in gilt yields over the same period.

Have equity markets gone up too far and too fast and, on the back of these strong returns, are they due a fall? Or, as considered in the chart on the right, are these just part of the normal cycle of returns? In 'Part I' of this paper, we consider the outlook for equities over the long term and the short term, before considering the options available to investors concerned that equities may be due a fall in 'Part II'.

Rolling 5-year average return on US equities (Standard & Poor's 500 Index)



Source: Aswath Damodaran (www.damodaran.com)

Part I: The equity story

Long-term outlook for equities

Fundamentally, we believe that the long-term returns from equities will be lower than what has become the norm for many investors. This is because there are a number of issues that will weigh on economic growth and subsequently equity returns should they remain unsolved.

These are:

- A lack of growth in productivity;
- Changes in demographics, principally ageing populations; and
- Current levels of debt across the globe.

None of these issues are 'forever' or unsolvable, but we believe they could plausibly last over the medium or long term.

Productivity

Ultimately, an economy grows through two sources:

1. An increase in the labour force (more labour creating more 'goods'); or
2. Labour and machinery being more productive (the existing labour force being able to create more 'goods' for each hour worked).

Productivity growth in developed countries has been slowing for at least 30 years and this slowdown has become more pronounced over the past decade. In the late 1990s, productivity in the US was growing at 3% per annum versus 0.5% per annum over the last three years¹.

Without a notable pick-up in investment to reverse this trend - which does not seem forthcoming - economic growth will be held back.

Demographics

The issue of populations ageing across global economies has two implications that could restrict future returns from equities:

- Firstly, as the population ages, the workforce as a percentage of the total population diminishes, reducing the labour force. This affects the level of output and thereby impacts economic growth and future equity returns.
- Secondly, the demand to access savings is higher in an older population as they prepare for retirement by focussing on safer assets rather than risky investments. This reduces the demand for equities, resulting in downward pressure on the price.

Debt

Many argue the global financial crisis was a result of too much debt. Since the onset of the crisis, global debt levels have continued to rise, not fall.

Whilst increasing debt is not necessarily prohibitive to economic growth, several studies of historical data suggest that in developed countries, high levels of debt relative to the country's Gross Domestic Product (GDP) tends to lead to lower growth rates. As the debt challenge has not been resolved, we believe it will act as a drag on growth.

Conclusion - does this matter for equities?

Whilst the link between economic growth and equity returns at a national level is variable, at a regional or global level we believe it is strong. Therefore, **unless the current high levels of debt and low levels of investment and productivity are reversed – and this is done to such a level to counter the challenges from ageing populations – we believe that long-term returns from equity markets will be muted.**

Of course, expectations play a huge role in all this. If lower economic growth is already priced into markets then future equity returns need not be lower. However, as we consider in the next section, it does not appear that equity markets are pricing in 'low growth'.

¹ Barclays Equity & Gilt Study, 2017

Short-term outlook for equities

We do not profess to be able to forecast short-term market returns (we are not convinced anyone really can) and therefore that is not what we try to do in this section. As regular readers know, we are great fans of the Mark Twain quote, "History doesn't repeat itself but it often rhymes". In this section, we have set out some facts on where equity markets are priced and what that has meant for returns from these markets in the past.

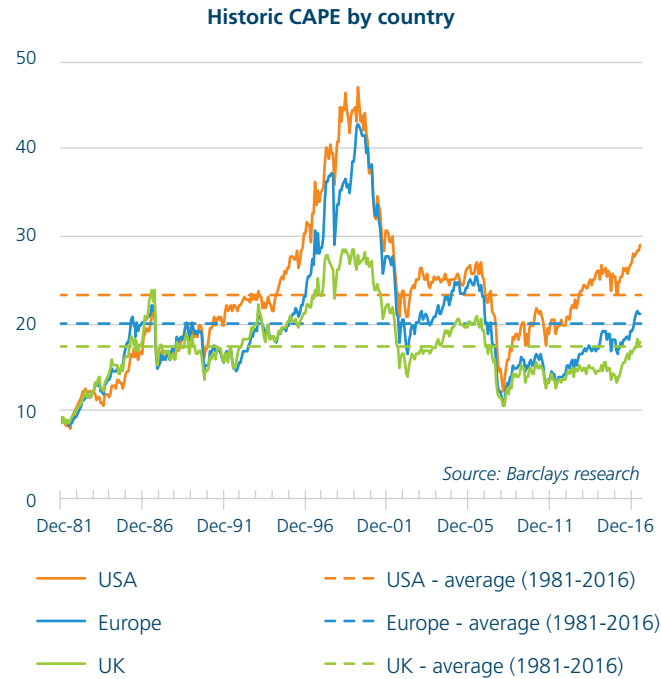
WHAT IS THE 'RIGHT' PRICE?

Before we get into details, it is worth considering how to determine the 'right' price for equities. With bond investments, this is far more straightforward as the returns are the known coupons and redemption payment. Once you then consider the risk of default, you can decide whether you feel you are paying a 'fair price'.

It is harder to derive a 'right' price for equities, as there is no guaranteed return. Dividend payments and growth in the value of the company – which are generated by the company's actual and expected earnings – cannot be known in advance.

Comparing a company's earnings and output to its share price are common ways of forming a view on whether it is overpriced. Expanding this to the whole equity market helps us form a view on whether equities on aggregate are expensive.

Price versus earnings: The cyclically adjusted price-earnings ratio (CAPE) compares the current price of equities to the earnings of the corresponding companies over the past ten years. The chart below shows how this has moved in a number of regions over the past 35 years:



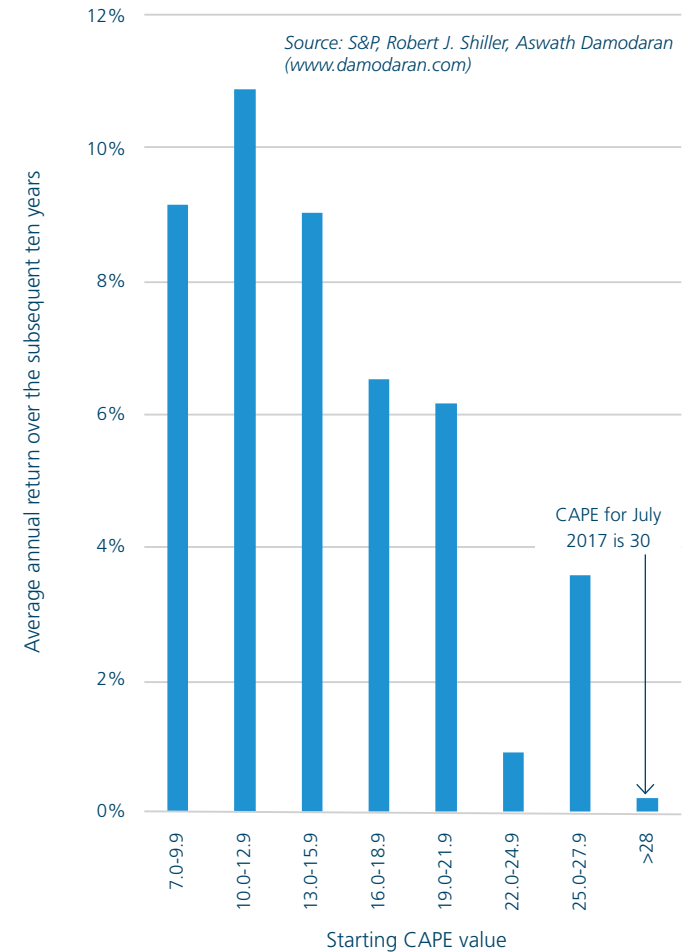
The above chart shows that:

- The UK and Europe are only marginally above their long run averages;
- However, the only times when the CAPE has been higher for the UK and Europe were in the run up to Black Monday in 1987, during the 1990s 'tech-bubble' and in the run-up to the Global Financial Crisis;
- The US is notably above its long run average. Going back in history, the US market has only ever been more expensive in 1929 and during the 2000 tech-bubble.

What has happened before?

We set out below what historic CAPE values have meant for investment returns over the subsequent 10 years:

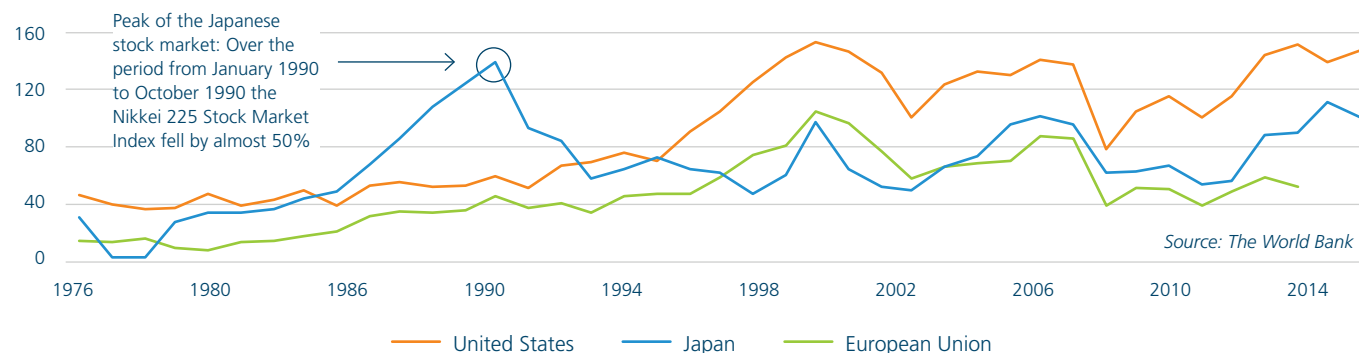
Link between starting CAPE value and equity returns over the next 10 years (US, S&P 500)



The chart shows that in the past a CAPE value above 28 (where the current CAPE value lies) has been followed by a very low return on equities over the next 10 years.

We have focused on CAPE as the measure of equity values but other metrics show a similar story. One of Warren Buffett's favoured measures is the size of the equity market compared to GDP of that country. When this ratio is high, it suggests equities are overvalued. This is shown in the chart below, which draws us to the same conclusion as above: the US market is more highly valued than other regions as well as when compared to its own history.

Market capitalisation of listed domestic companies as a percentage of GDP



Is this time different?

It is argued that with interest rates so low, these high equity prices (relative to history) are justified. Whilst this could explain why equity prices have risen so much, it does nothing to suggest that future returns are robust. If anything, it is an extension of the concern around debt: that it has forced future growth to be brought forward, dampening prospects for future equity returns.

HOW MIGHT WE BE WRONG?

In developing our view on equities, we have given significant consideration to how we might be wrong:

- Timing** – We have been pessimistic for some time, yet over the last eighteen months the equity market has continued to rally; so at best, our concerns were too early. We refer back to our comment on the ability to predict short-term market moves.
- Impact** – We may have misjudged the impact of the economic factors discussed or how political or regulatory changes could affect markets. Technological change could yet reverse the long-term decline in productivity and growth.

Part I conclusion

Our starting position is that the US equity market is expensive when compared to its history. As a result, global equity indices are expensive as the US market accounts for over half of global indices (passive investors in particular should be aware of this). We think it is possible that the correction in pricing could come through low returns over the next five years, rather than a sudden sharp drop. However, the risk has to be that any bad news for the economy will be felt through an equity fall.

Other markets do not appear to be particularly expensive compared to history.

Part II: Protecting against equity market falls

So if you are concerned about the outlook for equities, what can you do about it?

The most obvious answer is to sell your equities and transfer into another asset class. However, there are a number of issues with this solution:

- Firstly, equities are not the only asset class to have experienced particularly strong performance in recent years and many other assets also suffer from high valuations at the moment. Whilst there are sub-sets of asset classes where value can be found, finding that value comes with a higher governance burden.

Rather than pick an individual asset class, investors could look to Diversified Growth Funds (DGFs). However, these are not without challenges and investors have been disappointed with recent returns in a number of cases.

- Secondly, the option of moving out of equities into cash carries a great deal of regret risk as judging the equity market peak with certainty is impossible. The hardest part of such a plan is knowing when to get back into markets and we do not generally believe this approach is suitable.
- Thirdly, some investors will take the view that equities will continue to be the highest performing asset class and therefore it is desirable to maintain an investment in equities regardless of short-term concerns.

As such, we have focused the rest of this paper on a possible approach for those investors in the third camp: i.e. those that want to retain their equity exposure but have concerns over the short term and therefore wish to protect against some of the downside risk.

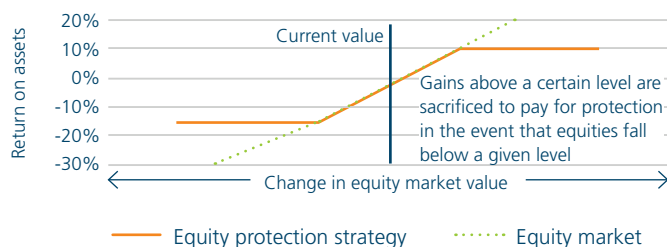
The industry-coined term for this is "Structured Equity Strategies". These are not new, but over recent years there has been an increase in the number of pooled funds offering these strategies, making them more accessible to small and mid-sized investors.

How do these strategies work?

There are several ways of building these strategies, combining different derivatives to provide the investor with a level of equity exposure to suit them. We have provided a simple example of one way derivatives are used in the diagram below.

In this example, the investor has used derivatives to reduce the range of returns on their equity portfolio to a maximum gain of 10% and a maximum loss of 15%.

Return structure of an example equity-protection strategy



Conceptually, such approaches take the view of 'selling' some of the high equity returns (after all double digit returns are not expected in strategies and so are not relied upon) and using the proceeds to 'buy' protection against a fall in markets.

Does such an approach make sense and what challenges does it present?

Impact on expected return: Such an approach will reduce the expected return from your equity portfolio. The amount by which it is reduced depends heavily on the specifics of the strategy, but a drag on performance of perhaps 0.5% to 1% per annum is a reasonable starting assumption.

This reduction in return may be acceptable to many investors, especially if it means they do not have to worry about significant equity falls. Furthermore, relative to other return-seeking assets, the expected return even allowing for this reduction – with the added benefit of a cap on potential losses – might still look attractive.

Control: The real advantage of these strategies is control; you can maintain some or all of your exposure to equities, whilst removing the risk of significant falls. For example, this could be useful if equities make up a significant proportion of the portfolio but the sponsor could not afford the additional contributions if equities sustained large falls.

Tactical play: Structured equity strategies may be long-term strategies used by investors to control risk or a short-term tactical play if investors are concerned about short-term falls in equity markets.

Governance: The governance needed to operate these strategies is significant and from our perspective, the biggest drawback to using them. This is because the value of the strategy changes over time and as equity markets move. As such, the strategy requires ongoing monitoring in order to judge the best time to exit.

Costs: These will typically be higher than passively managed equities, but in line with or lower than many actively managed equity funds or diversified growth funds.

Pooled funds: As noted earlier, pooled funds are a relatively new market development and there are still only a limited number in use. Despite that, we are already seeing considerable divergence in the structures used. The key drawback of these funds is that they do not allow the structure to be tailored to the client's risk appetite, return requirements and timescales in the way that a segregated strategy can - removing one of the key attractions of these strategies.

PART II CONCLUSION - IS 'STRUCTURED' EQUITY THE ANSWER TO OUR CONCERNS?

There are some schemes with very specific scenarios when using derivatives to remove possible losses on equities would be suitable.

For most investors, we think a better way to protect against the impact of equity market falls is to reduce the size of their equity holdings and look to hold a diverse portfolio of assets that will perform well in different market conditions.

Overall conclusion

We remain concerned, as we have for some time, over the level of equity markets. We encourage investors to keep a close eye on their exposure; at the very least, we encourage them to 'take' the 'excess profits' they have made over the past five years and rebalance portfolios. For those with a high equity weighting, we feel now would be a sensible time to review whether this remains appropriate and consider alternative return-seeking assets.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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