Equities

ARE THE ODDS EVER IN YOUR FAVOUR?

WHITE PAPER

Kempen

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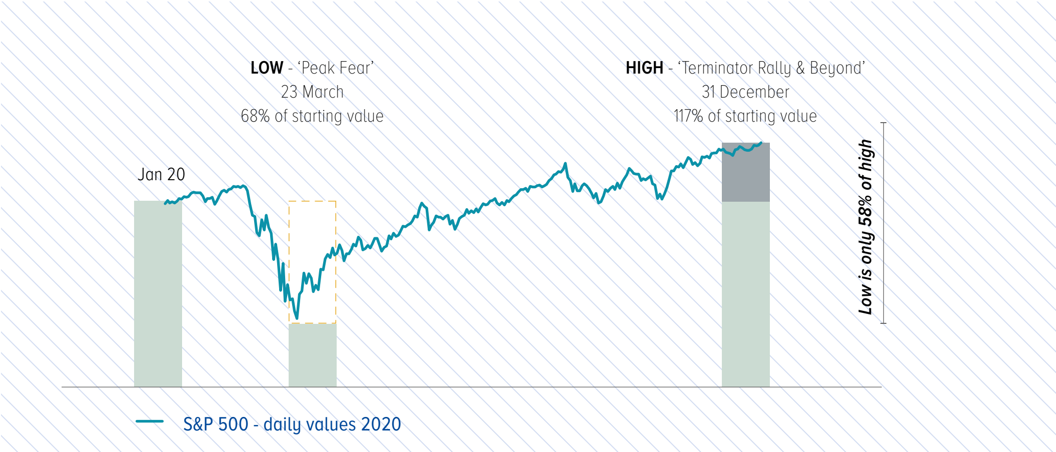
Introduction:
the risk or the reward?

Equities form the bulk of many investors' portfolios. If 2020 has taught us anything, it's that they are also very volatile. Often, it's hard to know if this is an accepted compromise for the end result, a positive for those that believe they can time markets, or just an unnecessary and avoidable risk. Take the S&P 500 performance over 2020.

FIGURE 1 S&P 500 performance in 2020



Source: Kempen, Bloomberg

Ultimately a good year, but not if an investor had to sell down before the recovery (and many couldn't simply be patient mid-panic). And whilst markets generally ended up, it wasn't a truly global story; the FTSE 100 ended down 14% as an example.

The questions this paper addresses is just how risky are equity investments, particularly for long-term investors. What sort of danger does this put investors in? Is there a better way of investing in equities, or should we focus on alternative assets (do we need to look beyond the venerable 60 / 40 portfolio)?

Investors increasingly alert to the dangers

UK defined benefit pension schemes have reduced their equity holdings over the past decade, but much of this decline comes from maturity and decreasing return need. If we look at just growth assets, we see the ratio equities to "other" (alternative) falling from 66% equity, 33% "other" in 2006, to nearly 50:50 in 2019[1].

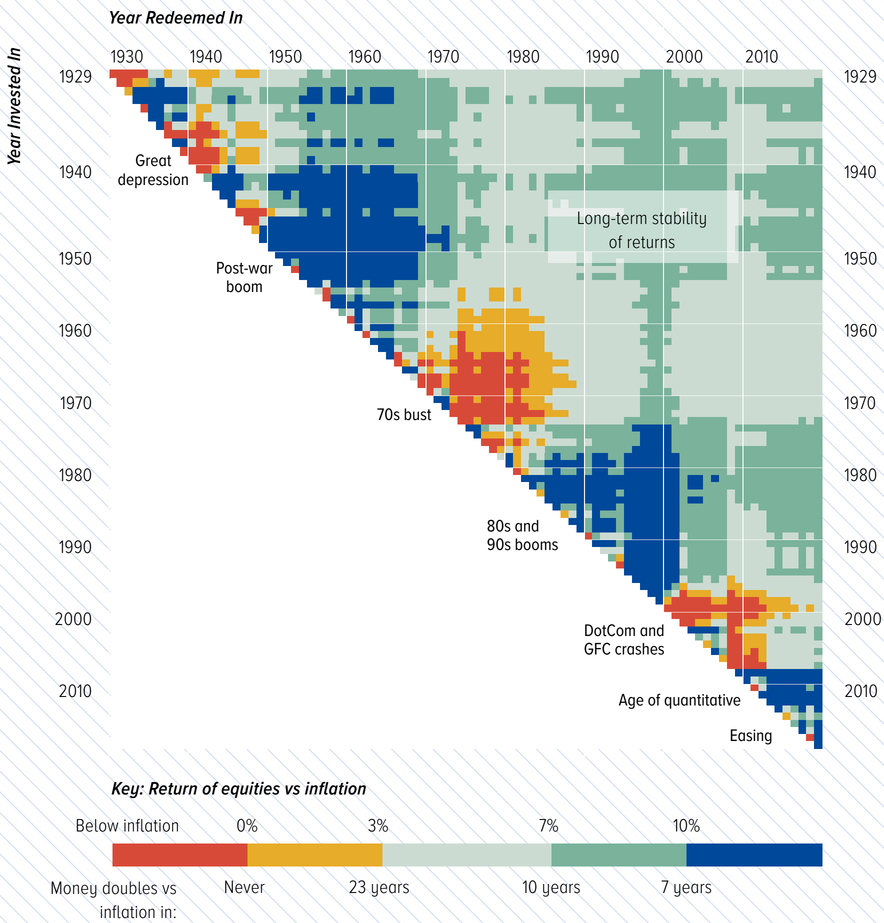
1 *PPF Purple Book, 2019*

This is a global story. The largest US endowments ($1bn+, historically heavy equity users) hold less equities (30%) than alternatives (40%)[2]. Smaller funds have higher equity allocations, which highlights it is larger (and more sophisticated) funds who are more alert to equity danger, or perhaps more capable of mitigating it.

What history tells us about equities?

History is a useful guide here. Below shows the returns of the S&P 500 (one of the longest equities series available) plotted against US inflation (really investors should want to make a "real" return).

FIGURE 2 What history tells us about equity returns: S&P 500 Total Return (incl. dividends reinvested) vs US inflation since 1929 (year invested and redeemed shown)



Source: Kempen, Bloomberg, S&P, FTSE

2 NACUBO, https://www.nacubo.org/Press-Releases/2020/US-Educational-Endowments-Report-5-3-Percent-Average-Return-in-FY19

What the chart and its annotations show, is that equity returns are vastly different depending on the year invested and the year disinvested (statistics below also include the FTSE All Share, post-1985).

- For shorter time periods returns are very volatile. Over a single year horizon (122 years analysed), 18% had a return of between 0% and 10% above inflation; 32% had below inflation outcomes; and 50% had returns in excess of 10% above inflation.
- Over 5 to 10-year investment horizons, these extremities fade. Moving from 1 year, to 5, to 10-year returns, below inflation return occurrences fall to 21% and 12% respectively and outcomes with returns over 10% fall at a similar rate from 50%, to 39% and to 32%.

> Those investors believing they are safe with a long horizon may be disappointed, although the odds seem in their favour.
>
> An 18+ year time horizon historically 'guaranteed' above inflation returns over the full period of analysis, falling to 14 years post the 1960s.

Regional differences do apply – over the same time period the growth orientated S&P 500 has had more extreme years than more value driven FTSE 100, but this volatility was rewarded with higher returns.
The impact of reinvesting, or not reinvesting dividends is enormous over the long-term. Focus just on the price movements of the indices (as many commentators do) and, even with a 10 year holding period there is a 32% occurrence of returns below inflation (vs 12% with dividends reinvested), whilst returns over 10% in excess of inflation fall from 32% of occurrences to just 8%. The holding period to (historically) 'guarantee' above inflation returns also increases from 18 years, to 28. So, what investors do with dividends is truly vital.

Where does this leave investors?

The above analysis suggests that there is significant horizon risk attached to equity investment. Approaches to manage equity risk could include:

1. Consider whether you truly have a long-time horizon
   This is not a choice for most investors, but a situational fact (alternatively, diversify your buying and selling over time, making you less time-dependent, although this does not protect from long-term equity return trends)
2. Consider diversification of sector, style, thematic and geographic allocations within equities
3. Try to time equity markets – volatility is a feature
4. Consider diversification into alternative assets

When investing over shorter periods than the 14/18+ year horizons mentioned above, which is relevant for many UK DB pension schemes, it is very uncertain if equities will generate the return the investor requires over their funding target periods. For those solely, or heavily reliant on equities, this places the industry at unnecessary risk.

For DC investors (individuals) the case for investment in equities is stronger reflecting their longer time horizon and gradual build-up of holdings over time (though provides an interesting context as to where contributions should be invested over time, and the pace of change to allocations as they approach retirement).

Only very long-term investors can confidently expect equity returns to be positive net of inflation, based on history. However, in practice there are relatively few of these investors, either because, like UK DB schemes, they need to liquidate to de-risk over time (and to pay benefits), or as is the case with many non-time dependent investors (e.g. endowments) they will change strategy over time and find they do not actually hold equities for as long as they thought they would.

The virtue of ignorance

Strangely it may only be the seemingly unsophisticated individual "buy and forget" investors who can take advantage of the very long-term equity premium of c7% over inflation (falling to 3% without dividends). However, deliberate ignorance is unlikely to present itself as a strong investment philosophy for the interested investor.

Doing equities better

The above analysis considers relatively naïve passive investment into equities (although not that naive, as most of the analysis assumes investment in the very profitable S&P 500, rather than other, historically weaker, equity indices). As well as seeing a growth in alternative assets, we have also seen a growth in demand for many styles, themes, sectors and geographies. At Kempen, we advocate the use of equities (there are precious few practical, liquid, similar cost alternative options), but believe investors can be more rigorous with the way that they allocate to the asset class. For example, ensuring:

- Diversification exists to reduce risk and capture return trends:
  - Capturing the demographic and geographic premiums with specific emerging markets – poorly captured alternative economic ecosystems like China
  - Small-cap equities – less efficient pricing, and more domestically focussed as we enter a period of de-globalisation
  - Thematic / decarbonization mandates – taking advantage of capital shifts towards the "green economy" and other megatrends
  - Use of specialised sectors within equities to replicate so called 'alternative betas'. Examples include the use of REITs and listed infrastructure securities.
- Meet individual needs – e.g. using dividends (with haircut) to meet income needs.
- Meet risk tolerances – using the (broad) equity options market to curtail downside risk (the trick here is not to "give away" too much upside in "insurance" premia)

Timing markets

This is fundamentally belief driven, with 'definitive' data pointing that it can or cannot be done often chosen selectively by the proponents and opponents. There are two key observations:

- If entry and exit into equities could be timed successfully there would be huge value
  In 2020 skipping out 19 February to 23 March of the S&P500 would have given a return for 2020 of 76%, compared to 16% if held through the trough – or 60% additional return, by missing under 5 weeks of the year. Clearly, this was a double-edged sword, selling out at the wrong time could leave an investor over 30% down.

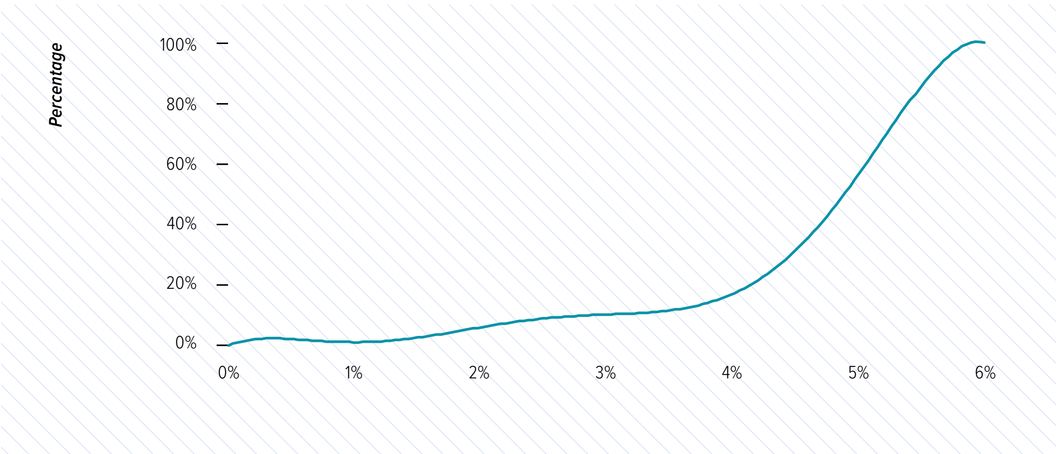
- But this is extraordinarily hard to do, and nearly impossible to do consistently
  Warren Buffet famously claimed "I don't even know anybody who knows anybody who has [timed markets successfully]"

Investors who focus on using equities as one of several drivers of returns are likely to be less concerned about timing markets, making this argument less relevant in the face of more robust portfolios as a starting point.

Diversification out of equities

Investors are increasingly looking to alternative assets to manage risk in their growth portfolio.

FIGURE 3 Allocation to equities (incl REITS) to generate return over risk free - historic



Source: Kempen, 2017 paper "Marvellous Simplicity", with underlying analysis revisited to create chart

The chart above shows the historic "optimal" allocation to equities (including REITS as equities) up to 2017[3].

3 *Source: Kempen, 2017 paper "Marvellous Simplicity", with underlying analysis revisited to create chart*

Interestingly the traditional 60% equity, 40% bond portfolio ties nicely with a return of 5% per annum over cash.

At target return levels of below 5%, significantly lower equity allocations were required to build an optimal portfolio. And the allocation to equities required at higher return ambitions may in practice be lower, as more aggressive alternative assets (which are difficult to capture in backward looking data) are underrepresented.

Looking forward, the behaviour and changing profiles of endowment and UK defined benefit pensions investors suggests that 33%-50% equities and 50-67% alternative assets may not be unreasonable for many balanced growth oriented portfolios of the future.

Other reasons to use equities

Equities do have a range of compelling features that many investors like, and cannot (as a whole) find elsewhere: daily liquidity, low costs (trading and ongoing), wide choices of strategy, regional exposure, sector exposure etc, as well as being easily and widely understood from a governance perspective and with data available on most constituents making things like ESG integration (or other tilts) more easily applied than other assets.

Conclusion: the wrap

Investors, particularly more forward-thinking investors, have become more aware of the risks that equities pose to their portfolio. History tells us that this is no bad idea; equities are far more volatile and can disappoint for far longer than most market participants expect, and, more importantly, can tolerate. With that in mind, investors should consider how their equity allocation is:

1) Balanced with alternative assets at the total portfolio level;
2) takes advantage of the latest thinking in equity investment, and
3) meets any specific needs or preferences they have.

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