Hedonism and the value of money – Part II

In this second part George argues the investment climate is getting tougher with bonds priced to deliver especially disappointing returns. However, equities should still comfortably outperform income growth over coming decades. To receive investment letters directly in future, please email info@equitile.com with 'Subscribe' in the subject header.

Selecting the right assets

In Part I of this investment letter, we argued that it is a reasonable long-term investment objective to 'keep up with the Joneses': that is to say, aim for investment returns that meet or beat income growth over the long run. This letter looks at which asset classes are likely to achieve this objective, given current market valuations.

Broadly speaking, investors have access to four main asset classes: cash, bonds, equities and real estate. Cash and bonds generate returns that are usually closely tied to either current or estimated future inflation, whereas the returns of equities and real estate are more loosely tied to nominal economic growth and therefore to income growth. At present we believe only one of these asset classes looks valued to deliver attractive long-term investment returns.

Historically cash has tended to offer a rate of interest close to, but slightly above, the current rate of inflation. Since 1961 UK inflation has averaged around 5.7%, while the return on cash[1] has been 7.2%, almost in line with the 7.3% average rate of income growth. Bonds similarly offer returns linked to inflation, though in their case the returns are linked to investors' collective estimates of future inflation over the life of the bond, plus some additional real yield to compensate investors for the risk taken. In periods where inflation turns out to be lower than investors anticipated, bond investors enjoy especially attractive real-returns. By contrast in periods where inflation is surprisingly high, bond investors suffer low returns and may even lose purchasing power in real terms.

Over the last half-century, inflation has been through some wild ups and downs but overall it has fallen: on balance there have been more downside inflation surprises than upside surprises. What's more, bond yields have now moved to forecast extraordinarily low levels of inflation for decades to come[2]. As a result, the returns on bonds have been particularly good in recent decades. Since 1961 the average return on UK government bonds has been 8.8%, comfortably outstripping inflation by 3% per year and even outperforming wage growth by 1.5% per year.

[1] Barclays Equity Gilt study, 2015. Average annual compound rate on UK T-bills between 1961 and 2015.
[2] Arguably, since the advent of quantitative easing whereby central banks purchase bonds for the purpose of suppressing long term yields, the bond markets can no long be considered to reliably forecast future inflation.

Perhaps more surprisingly the return on UK government bonds has even beaten the return on UK housing since 1961.

While investors in cash, bonds and real estate have done well, investors in equities have done significantly better. Since 1961 the UK equity market has generated an average annual return of 11.3%. To put that in context, had our hedonistic purchaser of an E-Type Jaguar in 1961 chosen to invest the £1,954 purchase price in the stock market instead of buying the car, they would now have enough money to buy three average British houses, with enough left over for an F-Type Jaguar to drive between them.

Probable success vs almost guaranteed failure

The statistics above illustrate how kind the last half century has been to investors; almost all asset classes have matched or outgrown income growth and most of them have done so dramatically. The fact that owners of assets have done so much better than workers for so long has now become an important political and social issue. For this reason, we anticipate policy changes which will rebalance future returns away from capital and back toward labour. For this reason, we believe the above backward-looking statistics should not be taken as a guide to future returns. We view both the UK electorate's decision to leave the European Union and the popularity of Donald Trump in America as early symptoms of a social discontent that will force this rebalancing.

If we are correct and policymakers do act to rebalance the benefits of economic growth toward workers, it will become much more difficult to achieve investment returns which match income growth in the future. We are especially concerned for the long-term prospective returns on cash and bonds, these being the asset classes where policymakers have the most direct control of prospective real and nominal returns.

The longest UK government bond matures in 2068 and currently offers investors a yield of just 1.6%. This yield is 0.4% below the 2% inflation target that the Bank of England is mandated to achieve. Assuming the Bank of England achieves its inflation target, investors in this bond are set to lose 20% of their real spending power by the time the bond matures. If, as we suspect, inflation surprises to the upside in the next half-century, the real loss of spending power could be much greater.

The chance of this more substantial loss of spending power is evident in the pricing of the UK government's 2068 inflation-protected bond, which is offering investors the extraordinarily low yield of -1.7%. Investors incurring a negative real yield of 1.7% until 2068 can anticipate approximately a 60% loss of purchasing power relative to today's basket of goods and services. If we assume an average 1.5% growth in real incomes until 2068, the loss of purchasing power relative to the future basket of goods and services could be closer to 80%.

We would urge long-term investors, concerned with providing income for future pensions, or endowments concerned with preserving inter-generational spending power, to think long and hard about what these bond yields imply for future spending power relative to future incomes.

As discussed, it may be that these negative real returns on capital have now become a necessary and inevitable part of a rebalancing of wealth from asset owners to income earners. That said, we suspect the burden of this rebalancing will be disproportionately born by bond and cash investors rather than equity investors.

While interest rate policies and quantitative easing have depressed bond yields to extraordinarily low levels, the effect on the valuations of equities has been much milder. According to the economist Robert Shiller's database the S&P 500 equity index, for example, is trading on a cyclically adjusted price earnings ratio of 26.5. This is equivalent to a real yield of 3.8%, which is certainly below the post-1961 average real yield of 5% but still comfortably above the likely future pace of real income growth. Equity valuations are certainly not cheap by historic standards but they do not suffer the extreme distortions of the bond markets. On top of this, their real yields still look comfortably able to generate investment returns high enough to keep pace with future rates of income growth. What's more, if we do see upside surprises to future inflation then we should expect company revenues to move higher reflecting those higher prices, thereby immunising investors to this risk – at least in the long-run.

In all likelihood, fifty years from now people will be consuming a bigger basket of goods and services filled with better quality products. But in fifty years' time consumers will have adapted their expectations to those new products – their expectations will be higher than those of today. A future pensioner, reliant on the proceeds of today's negative real-yielding bonds, may find themselves unable to afford even today's smaller and inferior basket of goods and services. Such a situation would imply a substantial future fall in relative living standards.

In summary, we believe aiming for investment returns that meet or beat long-term income growth is a sensible investment objective. We also believe equities are likely to more than achieve this result, whereas we expect the returns on bonds to fall far short of this goal.

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