

Equity investment for the private investor

Alan McIntosh, Cheviot Asset Management

The case for equities

Can go down as well as up

There is one simple maxim that participants in the market should remember – equities should be treated as a long-term investment. In this context an investment is defined as a purchase that, over time, produces a return above the rate of inflation, ie a real return. What constitutes the long term is a moot point but, in the case of equities, holding periods of 10 years plus should certainly be considered. That is not to say that large amounts of money cannot be made over much shorter time horizons, but such gains can be swiftly lost in a sudden market reversal. Recent history bears testimony to this. Having reached an all-time high of 6,930 at the end of December 1999, UK equities (as measured by the FTSE 100 index) fell to a low of 3,300 in March 2003 following the bursting of the internet bubble and the subsequent bear market. The FTSE 100 has still not recovered all of its losses.

As a result of this, equities have lost something of their shine as an asset class. Over the past few years many investors have re-evaluated their portfolios and, in some cases, reduced their exposure to equities, replacing them with an increased commitment to bonds as well as alternative asset classes such as private equity, property and hedge funds. Diversification is, of course, important within a portfolio, but the timing of any switch between asset classes will greatly affect the future returns that can be expected.

It was undoubtedly the case that a very positive disposition towards equities was built up during the 1980s and 1990s. In the UK, the total return (capital gain plus reinvested dividend income) generated by shares averaged 18.9 per cent per

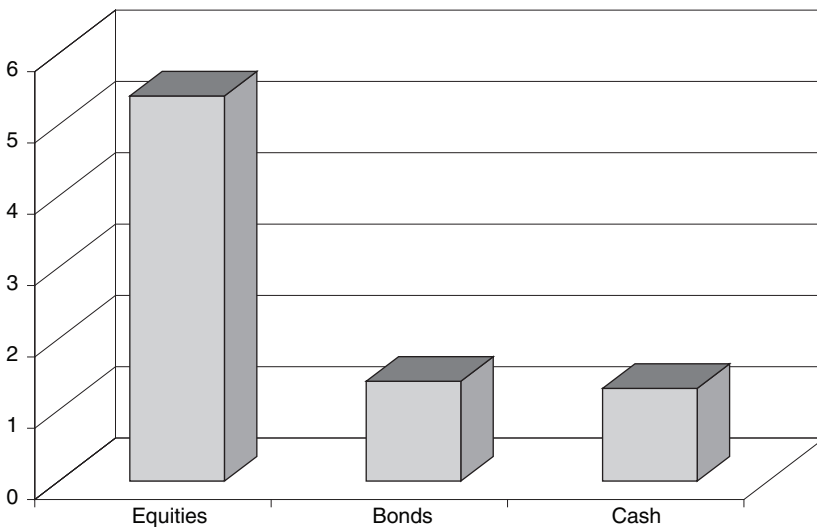
annum in the years 1983–99. This was substantially ahead of the returns enjoyed by government bonds and by cash, and served to reinforce the view that equities were indeed the asset class of choice. However, after three years of falling share prices over the period 2000–02 the pendulum, unsurprisingly, began to swing the other way, with equities seen as risky and volatile and, for some long-term investors, even deemed as an inappropriate asset class.

Good long-term returns

There is a danger, however, that a period of bad experience can change expectations unduly and lead to discouragement. What is important, therefore, is to try to determine what return can be reasonably expected from equities, compared with other asset classes, and decide whether there is a place for them in a portfolio, depending upon the investor’s time horizon and appetite for risk.

There have been a number of studies that have looked at the returns of various asset classes over time. The most relevant of these tend to look at real total return, ie both capital appreciation and income generation after adjusting for inflation. This is particularly important for long-term investors, as the purchasing power of the investment can be substantially eroded by inflation. Figure 2.3.1 shows the results of one of the most comprehensive long-term studies conducted in the UK.

As can be seen, equities have produced a better long-term return than either bonds or cash. Why should this be the case? There are two main factors that influence the rate of return on equities. First, the return required by an investor is directly linked to the risk-free rate of return that can be earned, for example on a government bond. In theory, investors should be willing to accept a lower rate of return from an investment whose future value is easily predictable, such as bonds and cash, and expect a higher return from an asset class that is characterized by



Source: Barclays Capital

Figure 2.3.1 Real returns (percentage per annum) 1900–2005

greater uncertainty. In the case of equities, this uncertainty includes the fact that dividends and future capital values are not known in advance. A period of rising interest rates would generally have a negative effect on share prices as the expected rate of return adjusts along with the risk-free rate of return. Of course, the converse should be true during a period of falling interest rates.

Secondly, the return on equities is influenced by corporate profits. Over long periods of time, corporate profits should grow broadly in line with nominal GDP. In the UK, the trend rate of real GDP growth is seen at around 2.5 per cent per annum and this is deemed to be consistent with an inflation target of 2 per cent. This gives a nominal GDP figure of 4.5 per cent. If, however, the 3 per cent received by way of dividends is also factored in, the real return expected from UK equities is $4.5 \text{ per cent} + 3 \text{ per cent} - 2 \text{ per cent} = 5.5 \text{ per cent}$. There are, however, times when the proportion of GDP represented by corporate profits will be rising, perhaps during a period of improving productivity, and this would generally be expected to provide a more favourable background for equities. Similarly, in recessionary times, if corporate profits are under pressure, equities might be expected to fare less well.

It can be argued that the period between 1983 and 1999, when annual equity returns were particularly high, benefited from the dual effects of falling interest rates (as inflationary pressures within the economy became more subdued) and labour market reforms, which helped to improve productivity and the GDP share of profits. Furthermore, such favourable factors are unlikely to recur imminently and it would thus be foolhardy to extrapolate the equity returns enjoyed over that period into the future.

Equities should still produce a long-term return above that of bonds and cash. Notwithstanding, investors should remain realistic in their expectations.

Constructing an equity portfolio

There is a variety of ways in which an equity portfolio can be constructed. This may include the incorporation of collective vehicles such as open-ended funds and investment trusts, the use of index trackers or active funds, or direct equity investment.

Collectives – index tracking or active investment?

In theory, the value of index tracker funds (or passive funds) – as the name suggests – will rise and fall exactly in line with movements in the market. Depending on the way in which the portfolio is constructed (faithful replication of index or representative sample selection) and the level of charges, the tracking error should be relatively low. However, an index tracker will not outperform a rising market and – owing to the inability to hold cash within the fund – will not outperform a falling market.

Another problem with the index tracking approach is that, at certain times, there can be tremendous areas of concentration in the market. A good example of this was the time of the TMT (technology, media and telecoms) boom in the late 1990s. At the market's peak at the end of 1999, TMT represented over 25 per cent of the FT All-Share Index and nearly 30 per cent of the FTSE 100. As these stocks

were pushed ever higher, index funds had no choice but to keep buying them since they have to maintain the exact weightings of stocks and sectors as they appear in the index. Even if these stocks are perceived as overvalued, the fund manager has no choice but to buy them.

Concentration can also take place at the individual stock level. Table 2.3.1 shows the top 10 stocks by market value in the FTSE 100 at the end of 1999. Thus, 10 stocks represented nearly half of the index. This is not just a quirk of that period, however. The top 10 stocks in November 2006 (Table 2.3.2) once again represented half the value of the index. For many investors, this may constitute an undesirable concentration of risk.

Actively managed funds seek to outperform the market through superior stock selection. Not only will the investor pay higher charges to participate within an actively managed fund, compared to an index fund, but regular studies show that

Table 2.3.1 Top 10 FTSE stocks by market value (1999)

Stock	% of FTSE
BP Amoco	8.7
British Telecom	7.0
Vodafone Airtouch	6.8
HSBC Holdings	5.2
Glaxo Wellcome	4.6
Shell T&T	3.7
AstraZeneca	3.3
SmithKline Beecham	3.2
Lloyds TSB Group	3.0
Marconi	2.1
Total	47.6

Source: Datastream

Table 2.3.2 Top 10 FTSE stocks by market value (November 2006)

Stock	% of FTSE
Royal Dutch Shell	8.5
BP	8.1
HSBC	8.0
GlaxoSmithKline	5.4
Vodafone	4.9
Royal Bank of Scotland	4.1
AstraZeneca	3.2
Barclays	3.2
HBOS	2.8
Anglo American	2.6
Total	50.8

Source: Datastream

relatively few funds consistently outperform the market. One of the main problems with open-ended funds is that, as they become larger, there is a tendency to increase the number of stocks held and thus the larger fund may take on the characteristics of a passive fund, but with higher charges. Moreover, cash flows can create further distortions. In a market downturn, if investors sell their units, managers may have to sell investments held within the portfolio in order to meet redemptions. They may have to sell the most liquid holdings irrespective of whether they believe these to be better-quality investments. Similarly, if the fund attracts new money, the manager may feel obliged to buy more stock rather than hold a large amount of cash.

Investment trusts are also collective vehicles, but are quoted companies in their own right. The purchase and sale of shares in an investment trust has no effect on the value of the trust's underlying portfolio (unlike open-ended funds, where the purchase or sale of units adds to or reduces the value of the portfolio). This means that the share price can move out of line with the value of the underlying investments, giving the investor an opportunity to pick up a portfolio of stocks at a discount to the net asset value.

Collective investments, be they closed-ended or open-ended, do have their place in an equity portfolio, particularly in the case of smaller portfolios where a reasonable spread of direct equities is impractical. More specialized funds can also be used to gain exposure to areas, such as emerging markets, where it may be difficult to choose suitable investments without particular local knowledge.

Active management using direct equities

How many stocks?

As the name suggests, this approach involves putting together a portfolio of individual stocks. With this approach, however, careful attention should be paid to diversification so that there are not areas of unnecessary risk within the portfolio. The first consideration is the optimal number of stocks. The risk in a portfolio comprises systematic risk and specific risk. Systematic risk is that which is common to all stocks, ie market risk. Specific risk is associated with individual equities but can be minimized by having an optimal number of stocks. Modern portfolio theory suggests that such optimal diversification can be achieved by holding approximately 15–20 stocks.

Once the right number of stocks has been decided on, there are further ways that an equity portfolio can be refined, namely by sector, by geographical considerations and by investment style.

Don't put all your eggs in one basket

There are clearly considerable risks associated with the strategy of single sector investment. For example, a portfolio composed entirely of water and electricity companies is potentially vulnerable to an adverse change in the regulatory regime affecting the utilities. Investors with portfolios composed chiefly of technology stocks were left exposed at the start of 2000 when the TMT bubble subsequently burst.

Going overseas

Another way of achieving diversification in an equity portfolio is through geographical selection. Traditionally, investment in overseas markets was to obtain exposure to industries not readily accessible in the home market. More commonly, overseas investment is seen as a way of taking advantage of countries where growth is faster than that of the UK, in anticipation of this being reflected in more rapidly rising equity prices. Investing in overseas markets also gives rise to currency risk, however, and this may impact on the returns available to a sterling investor, since a rise in the value of sterling reduces the value of non-UK investments. Notwithstanding, the benefits of geographical diversification would be felt if, for example, wage growth in the UK were to rise sharply, undermining company profits and competitiveness and thereby negatively impacting on the exchange rate. This would increase the value of overseas equity holdings.

Showing some style

Active management can also be divided by investment style. The two most common styles are usually described as *value* and *growth*. Value investing was perhaps best expounded by Benjamin Graham, who in turn inspired one of the most famous contemporary investors, Warren Buffett. The basic premise is to buy companies where the market value is less than the net current asset value. In periods of strong market performance, however, such bargains may be more difficult to find. More modern interpretations of value investing include buying companies with an above-average dividend yield – often these have depressed share prices or sell on sub-market price/earnings ratios because they are perceived as having fairly pedestrian prospects.

Growth investing, on the other hand typically, involves identifying companies with above-average earnings growth potential either relative to their peers or in a fast-growing industry or sector. Today, it often simply means focusing on capital growth rather than income. Growth companies often sell at a large premium to their net asset value (NAV), but the assumption is that the NAV will grow over time and should exceed the current valuation. Growth companies are often relatively young companies, and value companies are often very mature companies.

The difference in styles was easy to observe in the run-up to the market peak on 31 December 1999. The best- and worst-performing sectors over the previous 12 months are shown in Table 2.3.3.

Table 2.3.3 Best- and worst-performing sectors in 1999

	Change relative to the UK All-Share Index (%)
Information technology hardware	+593.7
Software and computer services	+112.5
Tobacco	-43.9
Water	-46.5

Source: Datastream

Technology stocks were in great demand because the perception was that the new information age promised enormous growth opportunities. Mature industries, by comparison, were seen as relics of the 'old economy'. However, these fortunes were soon reversed after the dotcom bubble burst, with technology stocks suffering dramatically, while the previously underperforming, low-growth sectors recovered sharply.

Proponents in both camps will argue that their style delivers the best long-term returns. The data behind this are ambiguous, and success can depend very much on where we are within the economic cycle.

Summary

The bear market of 2000–02 forced many investors to reassess their expectations about equity markets. Nevertheless, long-term data still suggest that equities should produce a better return than bonds and cash over time.

The construction of an equity portfolio will partly depend on whether the investor wishes to buy individual stocks or collectives, or indeed a combination of both. Collectives have a role to play, particularly as a way of gaining exposure to specialized areas such as emerging markets.

However, the active investor should not be put off the idea of having a portfolio of individual stocks. This can offer flexibility and, with a sensible spread of equities, extremes of valuation, or sector and stock concentration, can be avoided. Whichever approach the investor chooses, it is important to remember the simple maxim that equities should be treated as a long-term investment.