Distribution of equity returns

TORREVELL & PARTNERS WEALTH MANAGEMENT

Introduction

Most of our clients have exposure to UK and global equities as we believe that they are one of very few assets with the potential to provide capital growth and a rising income over time.

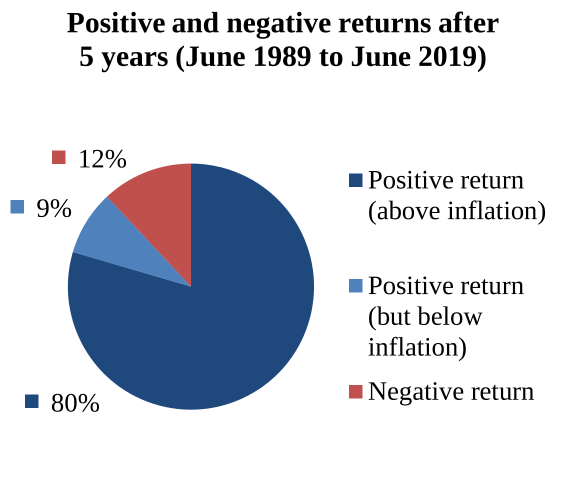
This article is an update on research we have carried out since 2014 and is based on the total returns generated by the FTSE All Share UK Equity market index over a series of rolling investment periods at weekly intervals over a 30 year period from June 1989 to June 2019. This period includes periods of heightened market volatility including the technology bubble of 1999/2000 and the global financial crisis of 2008/09.

Investing for the medium to long term. Is 5 years a reasonable period?

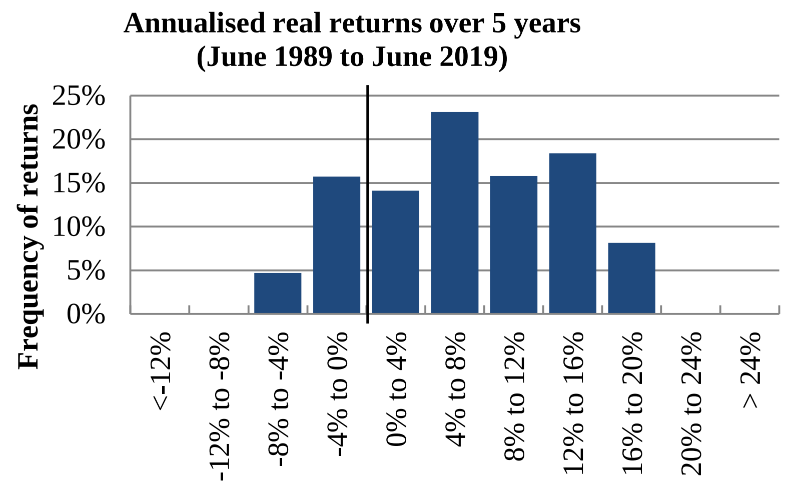
Equity investments are inherently volatile and short term movements of +/-20% are relatively common. In 2018 alone we saw two significant falls in the capital value of the UK equity market of over 10% in March and December. It is therefore typically said that clients investing in equities should be willing to hold these for the medium to long term (5 years or more). As a starting point we have looked at the results that investors in the FTSE All Share UK index would have achieved (before costs and charges).

The charts below summarise the total returns (including dividends) produced from a 5 year holding period over the past 30 years. Of the 1,305 discrete time periods in this analysis, investors would have generated a positive return in 1,149 of these. The probability of making a positive real return above inflation was around 80%, whilst the likelihood of making a loss in real terms was around 12%.

Figure 1



Source: Torevell & Partners analysis of FE Analytics data



Source: Torevell & Partners analysis of FE Analytics data

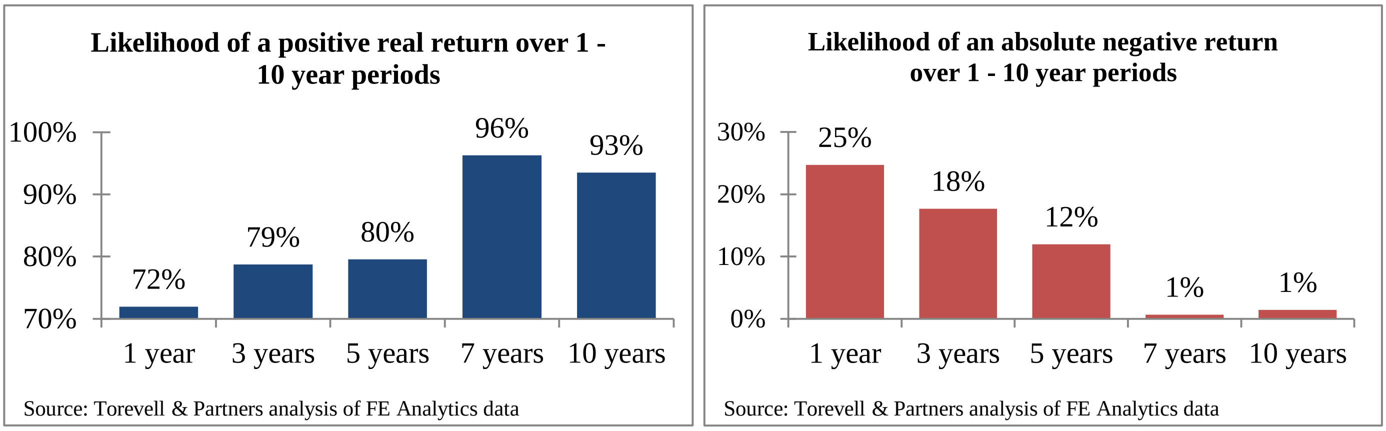
The right hand chart above shows the distribution of annualised returns (above inflation) investors in the UK market have achieved in any 5 year holding period over the past 30 years. The average 5 year holding period produced a total return of 53% above inflation (equivalent to average real compound growth of 7% per annum). Although this is a very positive result the spread of real returns (after inflation) achieved over a 5 year holding period ranged from **-** 33% to 166%.

Did holding shares for longer reduce the risk of losing money or improve returns?

Whilst holding shares for 5 years has provided investors with a high probability of generating an attractive real return, some investors might find the 20% chance of losing money in real terms (or a 12% chance of a fall in absolute value) to be unacceptable. We have therefore looked at the impact of holding shares for shorter and longer periods, ranging between 1 and 10 years.

Our findings in figure 2 below show that over the short to medium term (1-5 years) the possibility of an investor achieving a positive return above inflation was between 70-80%, while the chance of losing money in real terms was around 20-30%.

Figure 2



The greatest impact appears to be when investors held the market for <u>more</u> than five years. Over a 7 year holding period the likelihood of investors achieving a positive real return above inflation rose to 96%, while the possibility of receiving an absolute negative return fell to 1%. Interestingly, and counterintuitively, due to the proximity of the tech bubble of 2000/01 and the global financial crisis in 2007/08, our dataset shows the prospect of achieving a positive real return fell slightly for a 10 year holding period, although the chance of losing money in absolute terms remained extremely low at around 1%.

Not only did the probability of achieving a positive return rise from 5 years to 7 or 10 years, the distribution of possible returns narrowed significantly, with the minimum possible annualised real return increasing from - 45% over 1 year to approximately - 4% over 7 and 10 years. The series of charts in figure 3 below illustrates the narrowing distribution of returns.

Figure 3

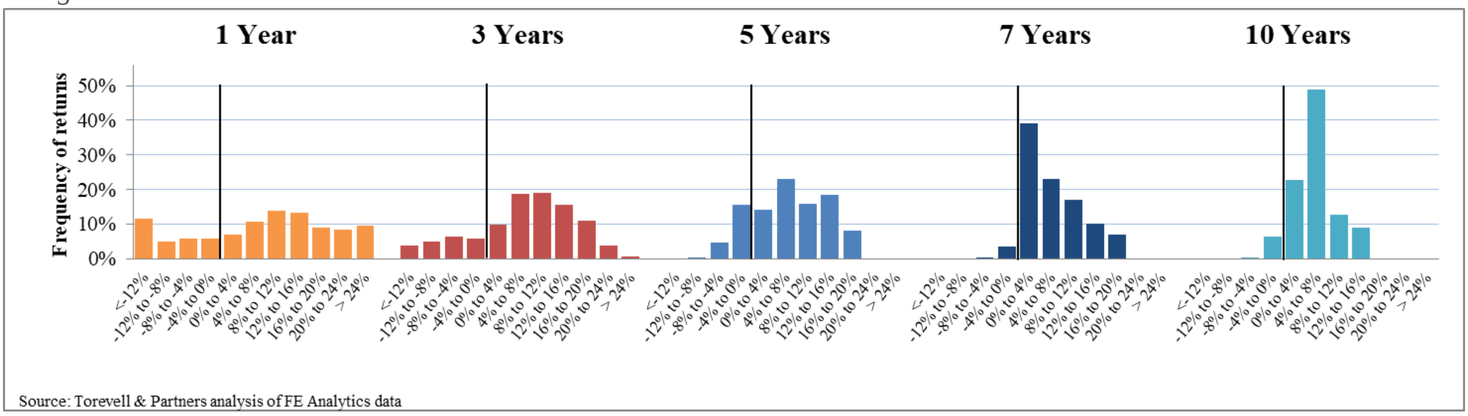


Figure 3 clearly shows that over the past 30 years holding shares in the UK market for longer periods significantly increased an investor's chance of receiving a positive return above inflation, whilst meaningfully reducing the possibility of a negative return. Over a ten year holding period the most likely outcome for an investor was a positive real return of between 4-8% above inflation per annum.

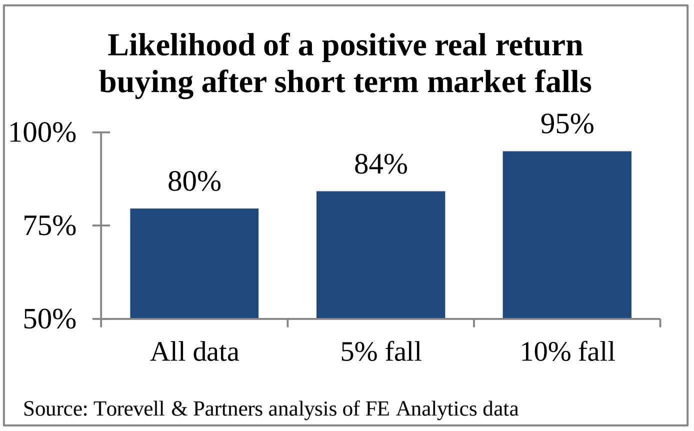
Does investing after a market fall affect the possibility of a positive return?

Investing into the FTSE All Share UK equity market on 30 June 1989 and reinvesting the dividend income over the following 30 year period would have resulted in a return of over 990%, or approximately 8% per annum before inflation. Whilst this is clearly an attractive long term return compared to the returns achieved by other asset classes such as cash and fixed interest, there are a significant number of periods where the price of the market has fallen from the previous 12 month high by over 5-15%. Over the past 30 years the market was trading over 5% lower than its peak of the previous 12 months on 40% of the weekly data points collected, and over 10% lower a quarter of the time.

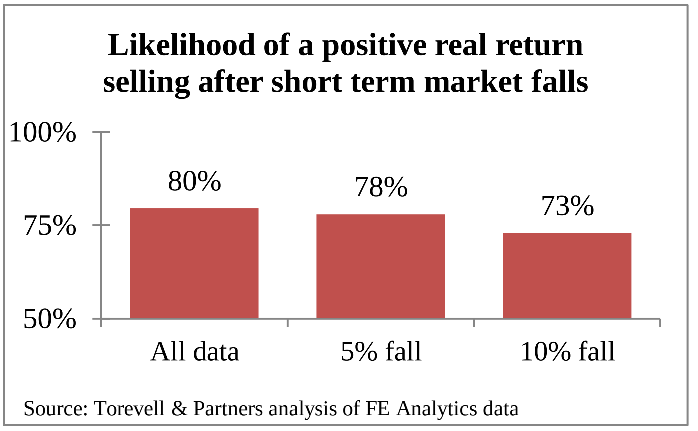
There are no guarantees that the market will immediately rise following falls of this nature, as shown most clearly after falls of over 15% in 2001 and 2008, which were followed by further significant falls in 2002 and 2009. For long term investors however the ability to take advantage of these market falls increased the likelihood of achieving a positive return overall.

As we have shown above, over the last 30 years the probability of an investor making a positive real return above inflation over a 5 year holding period was approximately 80%. The charts in Figure 4 below detail how this result changes due to short term market movements. Should an investor have bought into the market following a 5% fall, their probability of achieving a positive real return increased to 84%, and after larger falls of 10% this probability increased further to 95%.

Figure 4



Source: Torevell & Partners analysis of FE Analytics data



Source: Torevell & Partners analysis of FE Analytics data

Conversely, whilst selling investments after a fall of 5% or over from a market high did not materially change the probability of achieving a positive real return, investors who sold after a fall of 10% reduced their chances of a positive real return to around 73%.

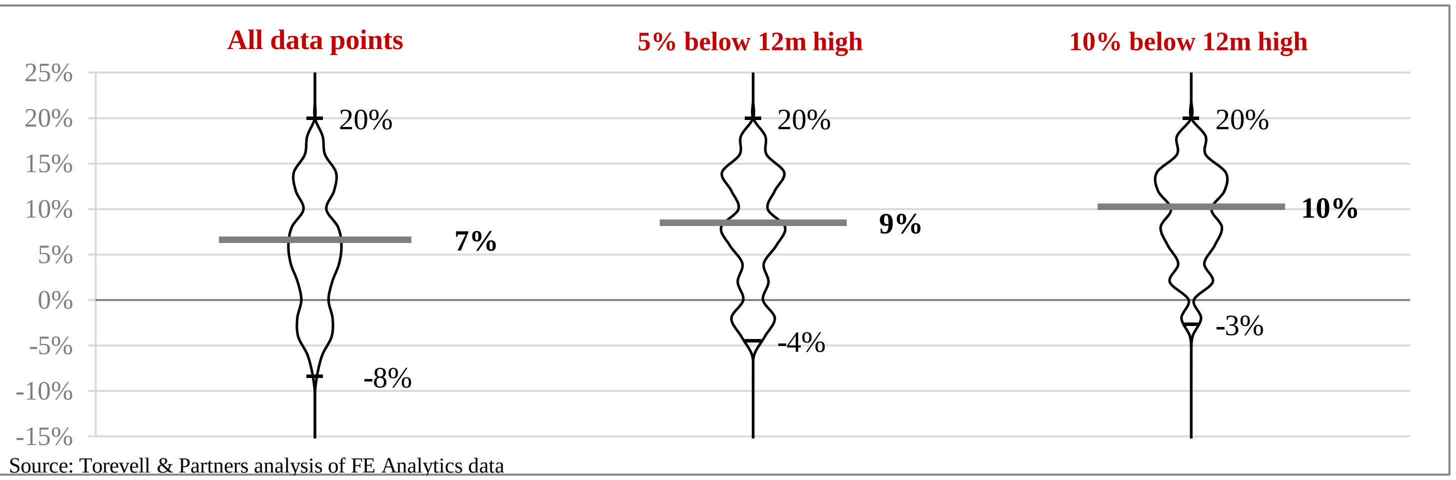
The data suggest the value of continuing to hold investments through periods of market volatility and avoiding the temptation to sell when prices are subdued. We advise all our clients to hold sufficient personal cash balances to cover any known or unforeseen short term expenditure to enable them to endure short term periods of market volatility and allow the value of their investments time to recover.

Where investors have funds available to take advantage of market falls they have historically been able to increase their chances of achieving a positive real return over a five year holding period.

How was the distribution of returns affected by investing after market falls?

Figure 5 below outlines the annualised returns achieved by investors if they had invested into the UK market for a 5 year holding period over the past 30 years, together with the returns they would have achieved if they had invested after falls of 5% or 10% from the previous 12 month high.

Figure 5



Source: Torevell & Partners analysis of FE Analytics data

There is a clear, positive shift in the distribution of the annualised returns generated as the level at which you enter the market falls. Investing while markets were down by just 5% increased the average real return above inflation from 7% to 9% per annum, representing an additional 13% return over a five year holding period.

Observations

Clients of Torevell & Partners will recognise that we only recommend equity based investments for investors who are looking to hold these for at least 5 years and where there is sufficient income or sources of readily available cash deposits in order to cover any known or unforeseen expenditure over the short term. Holding shares for longer than this helps improve returns and reduce the risk of losing money in real terms.

The data from the past 30 years clearly indicates that for those who are able to live with the inherent volatility of equity investment it is possible to achieve significant, positive real returns above inflation over a longer term period.

The table in figure 6 overleaf summarises some of the key results of our study. Whilst the average return for investors over all periods was positive the probability that investors could receive a (potentially significant) negative return over 1 and 3 year periods lends support to our position that equity investment over short periods is inherently speculative. Investors able to hold equities over the longer term have tended to be rewarded with an average annual real return of approximately 6-7% above inflation and a likelihood of losing money of only 1% over a 7-10 year holding period.

Figure 6

	1 year	3 years	5 years	7 years	10 years
Mean real return	7%	24%	43%	64%	91%
Mean real return (Annualised)	7%	7%	7%	7%	6%
Maximum real loss (Annualised)	-45%	-19%	-8%	-4%	-4%
Likelihood of a positive real return	72%	79%	80%	96%	93%
Likelihood of a negative return	25%	18%	12%	1%	1%

The data used reflects the returns achieved by the whole of the UK market over the past 30 years, but without any costs and charges. At Torevell & Partners we are strong proponents of actively managed strategies and we devote considerable resources to identifying those investments and managers that are able to produce consistent, attractive returns above that available from the UK market over time. In our experience we have found that over the longer term the best managers are able to outperform the market (after costs and charges) often with much lower volatility.

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