MLC Investment Management

Investment insight

The role of shares in a portfolio: what history tells us

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'Share market performance over different periods gives perspective on the role of shares in a portfolio.'

Investors seem to be at an interesting inflection point with regard to shares. On one hand, many are still pained by the losses of 2008. On the other, there is an awareness that term deposit rates are shrinking, bond yields are low, and shares can still deliver strong returns even if the world faces prolonged debt reduction.

This makes it an opportune time to take a step back and reconsider the nature of share investing and the role shares should play in an investor's portfolio.

This article offers no predictions. After all, few thought in March 2009 that the S&P 500 would deliver 23% pa over the next four years. Nor – despite the industry's propensity for confident-sounding predictions – does anyone know what will happen over the next four years.

Instead, I examine the last 112 years of share market returns through the lenses of three different time periods. This can give investors a balanced, objective and long-term perspective to withstand the emotional flux caused by capricious markets and excitable media.

Lens 1 – the very long run

Historically, as we know, investors have generally done well investing in shares over long periods. There are logical reasons why we expect this to continue to be the case. In essence, it's a bet on 7 billion people (and counting) waking up each day and finding ways to be more productive, and then finding new ways to spend their money.

Chart 1 on the next page shows rolling 30 year real returns (returns above inflation) from global shares, as well as bonds and cash, since 1900. It's worth remembering that these returns have been generated through wars, pestilence, financial crises, bubbles and busts.

While some periods have been better than others, we can see that over every 30 year period, investors have been rewarded with a positive real return from shares − that is, their spending power has grown faster than inflation. Shares have also consistently returned more than the other mainstream assets – bonds and cash – which have both failed to keep up with inflation for prolonged periods.

A secondary observation is that a man with his feet in the freezer and head in the oven is, on average, at a comfortable temperature. In other words, while the average outcome has been very good, investors have had very different experiences even over 30 year periods (ranging from less than 1% pa to just over 10% pa). Despite this, over 30 year periods, shares have been a rewarding investment.

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Lens 2 – the short run

Intellectually, we can all appreciate the benefit of this long-term focus. However, the reality is investors often react to short-term market volatility, of the type shown in Chart 2, because of the emotional and financial pain it causes.

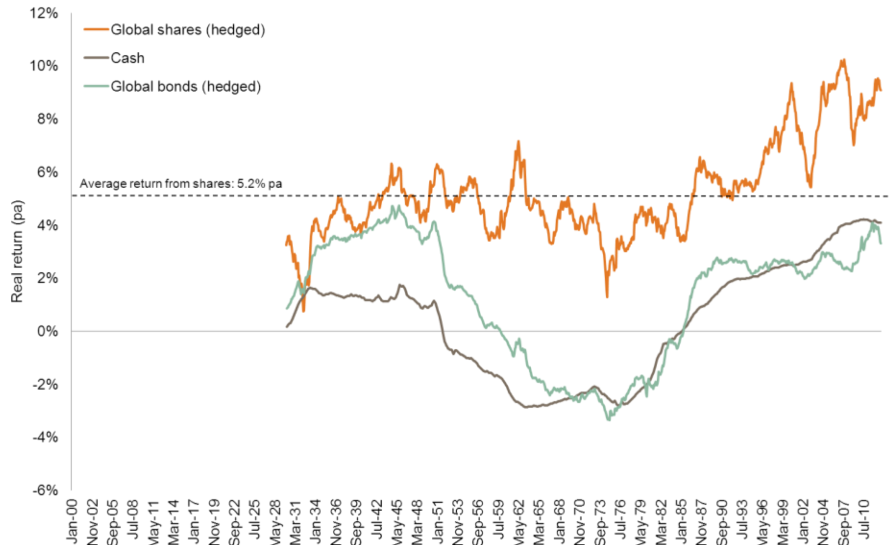
This emotional pain matters in determining an allocation to shares, because it creates 'switching risk' – the risk that investors react to short-term performance in ways that are wealth-destroying. We sell after shares have fallen, when the pain becomes too great, and we buy after shares have gone up, once the fear of missing out on profits exceeds the fear of losing money.

A key benefit to retail investors of having the guidance of a financial adviser, and investing in a diversified portfolio of shares and other assets, is to avoid this type of self-harm.

The other reason short-term volatility can really matter is what's called 'sequencing risk'. This is the risk that the year of big negative returns happens when an investor's superannuation pot is at its largest, close to retirement.

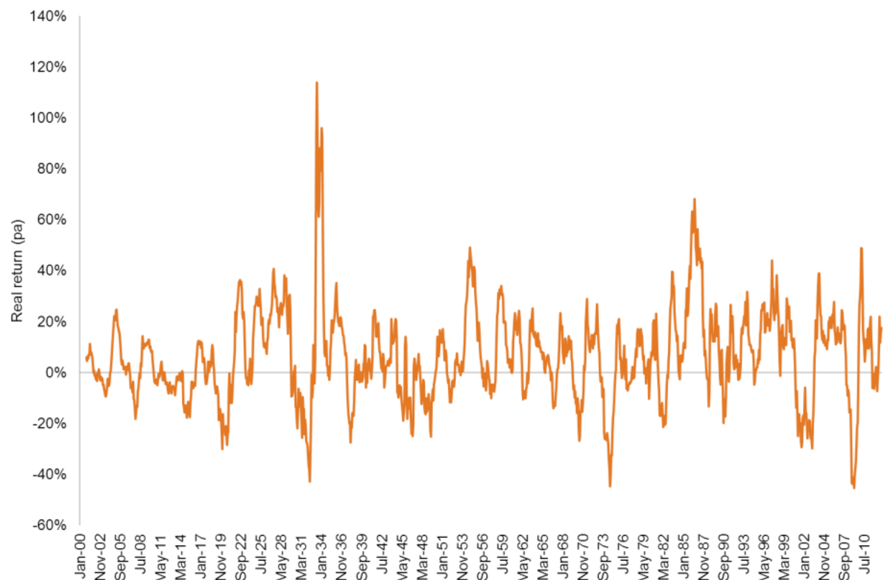
Both of these factors – switching risk and sequencing risk – suggest investors and their advisers do need to factor in the reality of short-term volatility when determining an allocation to shares.

Chart 1: 30 year rolling real returns (1900-2012)



Source: MLC, with data from Global Financial Data, Inc.

Chart 2: One year rolling real returns from shares



Source: MLC, with data from Global Financial Data, Inc.

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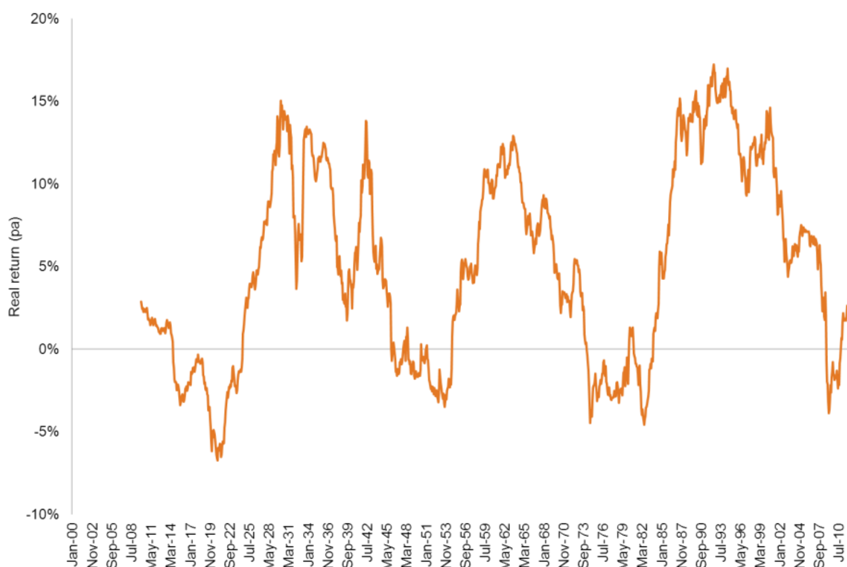
Lens 3 – 10 years

Ten year periods are the final lens through which it makes sense to consider share market performance. This is arguably a more realistic 'long-term period' for investors and advisers to focus on than 30 years. Chart 3 shows real returns for global shares over rolling 10 year periods.

The chart shows that, more often than not, shares have generated very attractive returns over 10 year periods. Indeed, 26% of 10 year periods saw real returns of more than 10% pa. But perhaps surprisingly, it also illustrates that in over 27% of 10 year periods, shares delivered negative real returns.

Chart 3: 10 year real returns from shares



Source: MLC, with data from Global Financial Data, Inc.

What conclusions can we draw?

1. It makes sense for most long-term investors to have a meaningful allocation to shares
- Very likely to have a higher long-term real return than bonds and cash.
- Likely to outpace inflation and support future spending.

2. Share performance can be very volatile and painful to investors in the short term
- Can cause clients to switch at the wrong time.
- Fear of volatility may also lead investors to invest in more conservative asset classes over the long term, missing out on the potential for higher returns.
- If a bad year coincides with retirement, it is a big deal.

3. Shares can also deliver negative real returns over 10 year periods
- As below-inflation returns are possible, investors shouldn't have all their money in shares.

It follows that finding attractive alternatives to shares – strategies that can deliver positive returns that are mostly independent of share market performance – is hugely valuable to investors. We will explore the potential and pitfalls of some of these strategies in future articles.

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