



Asset class returns - the past and the future

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A lot of attention has been focussed on the recovery following the 2008/09 market correction. Prior to the global financial crisis, we saw major corrections or pull-backs in 2000 and 1987. What we do know is that these are periodic events relating to market dislocations and corrections. All things being equal, they are surprisingly frequent and we know they will recur.

Despite the corrections mentioned above, owners of financial assets in the US for example have over the past three decades enjoyed a real (after inflation) annualised return of around 8% from both stocks (S&P 500 universe) and bonds (30-year treasury bonds). What makes this so extraordinary is that both asset classes have performed so well over the same period. The reasons for this achievement are numerous with the major drivers being falling inflation, falling interest rates, improved corporate productivity, profitability and finances, and rising valuations. In addition, in the mid 1980s, equities accounted for only 24% of households' discretionary portfolios – with cash and bonds preferred while by the end of 2013, the asset allocation for equities and deposits had broadly reversed with the former at 54% and the latter at 29% (BCA Research).

Can we expect the same or better returns in the future? Looking at the drivers mentioned above there are some formidable headwinds. If developed market inflation falls any further, deflation will become a serious threat, which would be bad for the economy, earnings and hence stocks. Short-term interest rates may hover around zero for longer but will inevitably normalise. Corporates have, in general, been very good at increasing margins, helped by falling interest rates, a weaker dollar and falling tax rates for example, but will find it more difficult to continue to increase margins in the future. The trailing PE of the S&P 500 does not look extreme but is above the long-term mean. However, over the longer term there is a correlation between returns and valuations

and therefore corporates would need to continue to improve their earnings to justify their valuations. While there has been a clear shift into equities from bonds, as yields rise and cash and bonds become more attractive, we could see some rotation back into these asset classes.

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And so how do we stack up from a South African perspective? Owners of financial assets have also been very well rewarded over the long-term. For the past 25 years, equities have returned 9.7% in real terms per annum, listed property 12.6% and bonds 6.6%. Interestingly, following the correction of 2008/09, the past 5 years (ending 2013) has seen equities significantly outperform bonds with real returns of 14.5%, versus 2.3% for bonds, while listed property was the second best asset class producing real returns of 13.5%. South Africa however also faces some considerable headwinds going forward. Inflation is trending up and is now forecast to average 6.2% for 2014 – above the upper 6% limit of the SARB. Although the Reserve Bank did not increase rates at the May MPC meeting, we are still clearly in a tightening cycle and "future actions will be data dependent determined by developments in the inflation outlook". The SARB revised their GDP growth forecast down sharply to 2.1% from 2.6% previously for 2014. Much of the weakness is due to the strikes and electricity constraints.

The MPC remains wary of the rand risks. At the moment, South Africa is attracting foreign flows and enjoying a 'safe haven' status due to the problems in other emerging markets but this could reverse. These foreign flows are extremely important and are

required to finance the current account deficit, which widened sharply over the past two years.

The MSCI SA consensus earnings growth expectations now stand at 15.6% for 2014 and 10% for both 2015 and 2016 with a trailing PE of 18X – given the risks mentioned above however, i.e. slower GDP growth forecasts and higher interest rates, there are clearly downside risks to these earnings forecasts.

This analysis shows that the returns generated for holders of financial assets both over the long term and post the 2008/09 market correction have been exceptional (i.e. well above the stated objective returns set for investments in such asset classes). This has been an extraordinary period and these types of returns are unlikely to be repeated over the foreseeable future. Although we remain confident

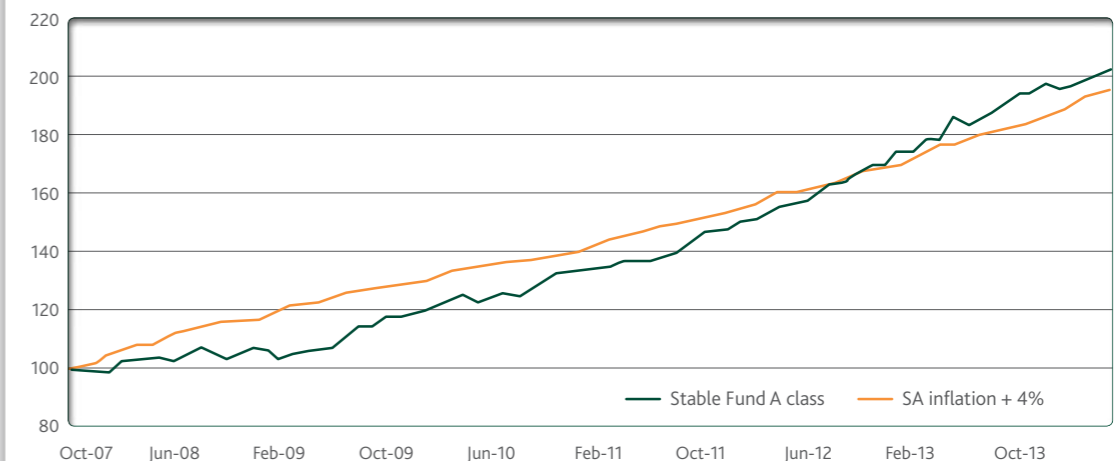
that our portfolios will achieve the stated real return investment objectives over the three- to five-year investment horizon, it is important that investors maintain realistic return expectations going forward and remember that wealth creation over the long term requires patience and persistence.

At Foord we seek to construct balanced portfolios such that the portfolio will deliver a reasonable outcome regardless of the market scenario that plays out. We think about risk in probabilistic terms and will dynamically adjust the portfolio accordingly. In addition, we would point out that investment markets are not static. We like to build portfolios that will strategically capture the 'long-term, slow changes' and we see volatility as opportunity, not risk. **DF**



For the latest views on the performance of this Fund, go to <http://www.nedgroupinvestments.co.za/videos>

Nedgroup Investments Stable Fund: cumulative returns since inception



Sources: Nedgroup Investments, Morningstar

Foord Asset Management was founded in 1981 and has one of the longest track records in South Africa. They have managed the Nedgroup Investments Value Fund since 2004 and the Nedgroup Investments Stable Fund since its inception in 2007.