



## The Lost Decade

The Barclays Equity Gilt Study has been published continuously since 1956, providing data, analysis and commentary on long-term returns from financial assets in the UK and US over 109 years.

The purpose in publishing this data is to provide investors with a perspective on long-term asset returns. In the 2009 study, it examined, amongst other things, the causes of the very poor equity returns of the past decade.

Equity investors have been on a wild and ultimately disappointing ride over the past decade. Equities have been the worst performing asset class since 1997, sharply underperforming all other asset classes.

Equity returns over the past decade have been among the worst on record. In nominal terms, the -0.3% annualised return from US equities since 1998 is the fourth-worst 10 year return of the past 83 years. Only those 10 year periods ending in 1937, 1938 and 1939 have delivered lower returns. Similarly, over the past 109 years, only the decade ending in 1974 saw a weaker 10 year nominal return from UK equities. For the sake of record, the 1964-74 UK equity return was 1.02%, while the 1998-2008 return was 1.05%. In both the US and UK, the real total return (taking inflation into account) from equities over the past decade has been negative.

As a natural reaction to this long phase of poor returns, there has been much talk of the death of the equity 'cult'.

The weak returns from equities over the past decade are not due to some intrinsic problem with the asset class. Rather, with the benefit of hindsight they are attributable to the extreme overvaluation of equities at the start of the decade after the technology and telecom bubble. Although the growth in corporate profits has been robust over the period in question, investors were paying a very high premium to access these profits at the start of the decade. This premium has hampered, not to say eradicated, positive returns.

Investors are often prone to the "recency effect", believing that because something has just happened it will continue to happen. A look at what has happened when previous decades have produced negative returns shows us that the following decade normally provides solid returns, which reflect the fact that investors are paying a low price to access corporate profits.

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## Real Investment Returns over previous decades

	Equities	Gilts	Index-Linked	Cash
1908-18	-3.5	-7.4		-4.8
1918-28	10.3	7		6.9
1928-38	3.6	6.7		2.4
1938-48	3.9	0.8		-2.6
1948-58	7.1	-4.5		-1.8
1958-68	11	-1.4		1.9
1968-78	-3.5	-3.3		-2.7
1978-88	12.4	5.8		3.8
1988-98	11.1	8.7	6	4.7
1998-2008	-1.5	2.4	1.9	2.4

Source: Barclays Capital

## Risk Preferences and Economic Conditions

In good times people are often willing to take risks.

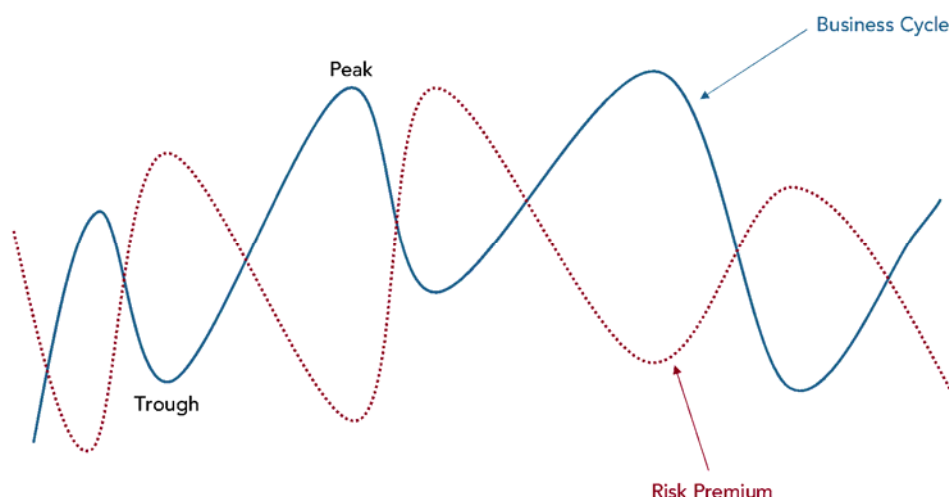
In bad times, uncertainties in the economy increase and people are afraid of taking risks and as a consequence:-

Most people will try to invest in safe assets (a "Flight to Quality") and Risk Aversion increases.

Unless risk premiums are higher nobody will invest in risky assets.

Therefore, to attract investors to risky assets, expected risk premiums should increase during bad economic times.

## Business Cycles and Risk Premiums



So expected returns on bonds and equities are lower when economic conditions are strong and higher when economic conditions are weak. (Source Fama and French, 1989, Journal of financial Economics). This is the opposite of most investors who prefer to "buy high and sell low". Our rebalancing strategy provides the ongoing discipline necessary to sell high and buy low.

## When is fund performance not Investor performance?

A recent study by Lukas Schneider of fund performance in this country states that "In the period from 1992 to 2003 the average UK equity fund return was 6.93 per cent while the average UK equity-fund investor achieved an average annual return of 4.91 per cent - about two percentage points lower than the funds he was invested in." Mr Schneider says that the explanation for this performance gap is that the fund figures assume that investors buy and hold the relevant funds for the entire time span studied. What investors actually do is move in and out of funds. When returns to investors are measured in a way that reflects this, known as an asset-weighted return, the figures are consistently lower than the stated fund returns.

Mr Schneider adds: "The picture is even worse when you consider that most UK equity funds do not match the performance of the FTSE all-share index, which beat fund returns by two percentage points over the period. So UK fund investor returns, taken as a whole, are four percentage points behind that of the FTSE All-share. Investors could improve returns considerably simply by doing two things. First, by adopting a rigorous buy-and-hold strategy, and not moving in and out of funds. Secondly, by purchasing index funds which, over the long term, tend to produce better performance, with lower costs, than conventional equity funds." A summary of the results from this study is given below:

### UK: 1992-2003

Measure	Annual Return	Growth of £1
FTSE All Share	8.99%	£2.81
Average Fund	6.93%	£2.23
Average Fund Investor	4.91%	£1.78

Source: Lukas Schneider, *An Examination of the Difference Between UK Fund Returns and UK Fund Investors' Returns*, July 2007.

**A Similar Study was carried out by John Bogle in the US and his results were as follows:**

### US: 1983-2003

Measure	Annual Return	Growth of \$1
Stock Market Return	13.00%	\$11.50
Average Equity Fund Return	10.30%	\$ 7.10
Estimated Equity Fund Investor Return	7.90%	\$ 4.57

Source: John C. Bogle, "The Mutual Fund Industry 60 Years Later: For Better or Worse," *Financial Analysts Journal* 61, no. 1 (2005): 15-24.

## Surely Active Managers Outperform in Bear Markets?

One of the most enduring investment myths is the belief that active management has a distinct advantage in bear markets due to the ability to shift rapidly into cash or defensive securities.

The S&P Indices versus Active Funds (SPIVA) Scorecard reports performance comparisons corrected for survivorship bias (funds that folded or changed/merged), and is an annual survey carried out each year to compare active management against the relevant indices. This study dispelled this myth in 2003 using the 2000-2002 bear market, and the 2008 downturn has provided another opportunity to revisit this myth and the results are similar and are summarised below:

### Percent of active funds outperformed by benchmarks in bear markets

	2008	2000 to 2002
All Large-Cap Funds	54.3	53.5
All Mid-Cap Funds	74.7	77.3
All Small-Cap Funds	83.8	71.6
Large Growth	90.0	49.4
Large Core	52.0	53.4
Large Value	22.2	36.5
Mid Growth	89.0	82.4
Mid Core	62.3	70.2
Mid Value	67.1	82.8
Small Growth	95.5	87.5
Small Core	82.5	70.8
Small Value	72.6	58.3

Over the previous 2 full five year market cycles from 2004 to 2008 and from 1999 to 2003 the position is similar:

There are of course some managers that outperform but there is no reliable way of picking them in advance. This is why Hillier Hopkins don't pretend that we can, instead we concentrate on buy and hold and delivering asset class returns at the lowest possible cost with a sensible rebalancing strategy to take advantage of asset price cycles.

With thanks again to Simon Brown for his help with this article.

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