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111 years of lessons

Michael Nairne, Serious Money

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The winner in Credit Suisse Research Institute's recently released 2011 Global Investment Returns Yearbook was, surprisingly to many, not the U.S. which tied Sweden for third place. The winner was Australia with a 7.4% return.

Investment plans require a long-term focus – one that considers decades of possible Investment performance, not just next month's or next year's. A sound plan also incorporates the important lessons of the past and avoids excessive bets based on the prognostications of the latest hot guru.

That is why Credit Suisse Research Institute's recently released 2011 Global Investment Returns Yearbook is essential for any serious investor. Through its analysis of the real returns (i.e. returns net of inflation) of stocks and bonds over 19 countries from 1900-2010, the report reveals history's big lessons. Stocks were the standout winner over 111 years, besting bonds in every country.

Globally, stocks had an annual real return of 5.5% versus 1.6% for bonds. Investors planning their retirements should pay heed to the modest magnitude of both these returns.

Moreover, since inflation takes such a big bite out of bond returns, it is clear that equity exposure is essential for most long-term strategies. Some countries fared better than others. The winner in real stock returns was, surprisingly to many, not the U.S. which tied Sweden for third place. The winner was Australia with a 7.4% return. Another surprise was second place South Africa with a 7.3% return. It pays to be a leading producer of gold, platinum and diamonds. Canada came in a respectable fifth with a 5.9% return.

Italy, suffering the misfortune of two world wars, costly inflation and a declining currency, was last with a 2% return. Although we know with hindsight which countries outperformed, the rise of Asia and South America over the coming decades will result in different winners and losers. Fortunately, the lesson of the past isn't guessing who the winners are; it is the importance of global diversification. The annual real return of 5.5% for stocks globally beat the returns in two-thirds of the individual countries.

Yet, the volatility of the global stock portfolio was one-quarter less than that of the average country. Diversification's free lunch is truly global. Stocks didn't win all the time. Over the past decade, bonds beat stocks globally by 4.0% annually. Only in four countries, three of them resource rich including Canada, did stocks outperform bonds.

Similarly, in the 1930's, the real return from bonds far outpaced that of stocks. Investors need to plan for lengthy periods where bonds can outperform equities. Most investors know stocks are risky but what might surprise them is the frequency of major declines. While none of the bear markets that have occurred since World War II match the 79% real loss of the Crash of 1929, fully three times in the past half-century the U.S. market has suffered losses of more than 50% of its real equity value.

What many investors aren't familiar with is the riskiness of bonds. Bonds have also endured deep and prolonged downturns. In the U.S. after World War I, the real value of bonds declined by 51% over five years.

Then, from 1940 through 1981, bonds suffered a staggering 67% reduction in real value. The cause in both cases was low interest rates followed by a protracted bout of rising inflation. Critically, a diversified portfolio of stocks and bonds curtailed losses and recovered faster than either asset class alone. An equally weighted portfolio of these two assets in the U.S. had a real annual return of 4.5%, nearly three-quarters of that achieved by stocks alone but with only one-half the volatility.

Taking a page out of history, savvy investors today are even more diversified adding real estate, commodities and alternative investments to their portfolios. George Santayana, the philosopher, said, "Those who cannot remember the past are condemned to repeat it." Fortunately, the choice to remember is now ours.

-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto.