Global Matters Weekly

14 August 2023

# Decision time

by Alex Harvey

On Thursday last week I was presented with two looming Friday deadlines; producing the Global Matters Weekly blog and selecting a fantasy football team before the new season kicks off. Should I forego a season's worth of sporting entertainment and punditry in pursuit of the perfect blog, or click the auto-select button (but rue my decision in a few weeks' time)? If you are reading this, then I will have achieved at least one of those Friday goals (no pun intended). My fantasy team may have taken the back seat, but the auto pick selection may in the end prove better than my own.

Ultimately, my desire to field a team comes down to the mentality that you need 'to be in it to win it', which applies as much to investing as it does to fantasy football. The choice to be in the market, or not, is probably the single most important investment decision a person can take. Stock markets do go up over time, as the underlying companies grow their earnings through a combination of both sales growth and/or improving margins, with a proportion of these earnings finding their way back to equity investors through dividends (the 'payout ratio' on the MSCI UK and MSCI World indexes is around 42%[1] today).

Those dividends are a crucial component of total returns, boosting returns to global equities by an annualised 2.3%[2] per annum over the last 30 years, which when compounded more than doubles the simple index price return over the same period. In fact, the contribution to global equity total returns from dividends accounts fully for the 10 best days' returns since 1993. In other words, if you'd missed out on the 10 best trading days for global equities over the last 30 years – an often highlighted investment statistic - your annualised return would be 2.5% lower. 'Time in the market', not 'timing the market', as the old adage goes. Sitting it out can also be painful, waiting for a lower entry point as the market rallies higher. This fear of missing out, or 'FOMO', acts as a siren call. Eventually the investor capitulates, buys in late in the rally, and helps to give it that last hurrah. A classic human behavioural bias.

Granted, the stock market journey can be bumpy as earnings and valuations oscillate with the business cycle, but long-term investors can wear this shorter-term volatility – and in some cases benefit from it. In most markets, and the US in particular, there is a strong correlation between forward total returns and starting valuation, and buying cheap historically has yielded higher returns.

Today however, with a prospective price earnings ratio of 20.6x, the S&P500 does not look particularly cheap. The 4.85% earnings yield that backs out from that valuation does not look so enticing when Treasury bills pay north of 5%. The S&P500 equity risk premium is wafer thin today, and we see better long-term opportunities elsewhere, as my colleague Matt Connor discussed last week[3].

What companies may have though, which cash does not, is pricing power: the ability to pass on an increase in the cost of providing a good or service. As such, companies can shield themselves (and their investors) from the effects of inflation, which remains the key macro investment risk today. Equities arguably offer investors the best long-term inflation protection so they might just be worth paying for, and with cash rates expected to fall back next year, the lure of equities – and other risky assets - will become more appealing.

Inflation continues to trend lower in most countries, which is unquestionably a good thing for markets and ordinarily should encourage adding to portfolio risk. However other indicators, most notably labour markets, which remain tight and seemingly unaffected by the last 18 months of Federal Reserve hikes, would suggest more caution. At Momentum Global Investment Management, we have added meaningfully to our government bond allocations over the last year, and likely have not finished, as valuations in those markets continue to rerate. As policy rates near their endgame though, we would expect to see more rotation into risky assets, and any periods of weakness provide an opportunity to do that. So, in football parlance we're probably more '4-4-2' today. Which reminds me, I'd better get on with that team selection!

Sources:
1 Bloomberg Finance LLP.
2 MSCI World equity annualised returns from 31 August 1993 to 10 August 2023; price return 5.5% total returns 7.8%
3 https://www.bis.hk/undervalued-forgotten-opportunitiesufos-in-your-asset-allocation/

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For more information, please contact your adviser or alternatively contact:

Belvest Investment Services Limited
研富投資服務有限公司
9th Floor, Centre Mark II
305-313 Queen's Road Central
Sheung Wan, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
belvest@bis.hk
www.bis.hk


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