RETIREWELL
WEALTH MANAGEMENT SOLUTIONS

eNewsletter
Exclusive Client Email Newsletter
17 May, 2023

Five Charts on Investing - to Keep Tough Times like Now in Perspective

Important Introductory – and Explanatory – Comment

Inflation forces dramatic rise in "risk-free" rate of return – The average person has very little realisation of the **enormity** of what has occurred in investment markets worldwide, since March last year, when the US Federal Reserve first increased the cash rate, from 0% to 0.25%, to counter sharply rising inflation. The reason for the sharp rise in inflation has been due to worldwide intervention over a number of years since the Global Financial Crisis, by Central Banks in the setting of interest rates (Quantitative Easing - forcing rates to multi-century lows), massive worldwide Government spending during the 2020 pandemic, then supercharged by the Ukraine war. Since then, the so-called "risk-free rate of return" (the 10 year Government Bond rate), the 'measuring stick' of value against which the value of **ALL** investments is calculated, has risen from sub 1% to around 4% in all Developed economies, in a coordinated response to rapidly rising inflation. The speed and the size of this increase is unprecedented – *it has never been seen or experienced before, in modern history.*

Markets are still going through the shock and difficult process of the resultant (downward) adjustment to capital values. Assets which are valued and traded daily, on a 'mark-to-market' basis - such as shares and bonds (fixed interest securities) - saw immediate downward adjustments in value last year, as cash rates (and Government bond rates) were relentlessly increased -11 times since May 2022, in Australia, from 0.1% to the current rate of 3.85%. In the US, the increase has been even more dramatic, from 0% to 5.25% now. In the UK, the rate is currently 4.5%, in Canada it is 4.5%, in New Zealand it is 5.25% - all a far cry from zero or near zero rates a little over a year ago.

Why rising Government bond rates causes a loss in capital value – As a consequence of the dramatic increase in 10 year Government bond rates, the Australian Government Bond Index returned minus10.2% in 2022! How can you lose money on Government bonds, when interest rates are going up, I hear you ask? The reason for this loss, is that the interest rate on a bond is fixed – its capital value will have an inverse relationship to this fixed rate of interest. You can't fix both the interest rate and the capital value. So when the interest rate for a new Government bond increases from 1% to 4% – what happens to the *capital value* of the Government bond which is paying a fixed rate of only 1%? When the interest rate is fixed, the variable becomes the mark-to-market value (sale price in the public secondary market) of the 1% Government bond – it falls, so that the new buyer (paying a much lower capital value) will effectively receive the current 4% market interest rate, based on the lower price paid – even though the 'coupon rate' is still

fixed, at 1%. At the end of the 10 year bond life, the full face value of the bond is repaid by the Government. Note that the capital guaranteed value applies only at the maturity of the bond. Its value at all times between issuance and maturity, is determined in the secondary market, by reference to the current prevailing market interest rate – its value could be higher or lower than its face value, depending on whether current interest rates are above or below the bond's fixed interest rate. That's why the Government Bond Index in Australia fell over 10% during 2022.

How higher Government bond rates causes other assets to fall in value – Why do higher government bond rates cause the value of other income-producing assets to fall? The logic is this: why would you accept an uncertain 4% income return from shares or property, with no guarantee of return of capital - when you can now get a government guaranteed income return of 4% from a Government bond – with an absolute Government guarantee of return of your capital? Something has to give - and that "something" is the capital value of the share, property, or other asset. The asset price needs to fall, so that the same 4% dollar value rent or dividend income will increase in percentage terms, to a higher comparative value of (say) 6%. The only way this can happen, is for the price of the share or property, to fall. This reduction in value will compensate for the uncertainty of the income stream and the lack of any guarantee of return of capital - when compared to the Government guaranteed 4% income, now being paid on a 10 year Government guaranteed bond. Because there were significant losses in both fixed interest securities and listed securities, it is no surprise that values for publicly traded assets fell during 2022 and are moving sideways or only just starting to recover.

Price adjustments take longer for illiquid assets – Assets which are not valued daily (such as direct property, infrastructure and private equity) will all be going through the downward revaluation process this year, as the revaluation cycle catches up. To reiterate: all the values (prices) of everything – public and private shares, direct and listed property, fixed interest securities, infrastructure assets - have been or will be revalued downwards because of the dramatic increase in the "risk free" rate of return from 1% to 4%, in a little over a year.

Inverse Relationship – It is easy to see why people find it difficult to understand the inverse relationship between the fixed interest return and the capital value of a Government bond - it is counter intuitive - and why the same valuation methodology gets carried through to the valuation of ALL other assets. In other words, why a perfectly good and sound asset (such as a quality share or tenanted property), paying the same (say) 4% income return – will suddenly fall in value, when Government bond rates rise.

We hope the explanation above will help to explain this asset valuation phenomenon. This adjustment/ reduction in the capital value of all income-producing assets applies across the board, to all assets. It is a phenomenon which many people will find difficult to understand and accept. It is an almost once-in-a-lifetime event, given that it has not occurred before, in living memory. This sudden dramatic rise in interest rates is here to stay and is likely to be permanent. The cost of money and capital – as reflected in the interest rate – is returning to its long-term base rate of around 5% per annum. Money is no longer free.

Key Message: In difficult times like the present, investors need to be patient, sit tight and stick with their long-term strategies.

Key points in this Newsletter

- Successful investing can be really difficult in times like now with immense uncertainty around inflation, interest rates, issues in global banks and recession risks impacting the outlook for investment markets.
- This makes it all the more important to stay focussed on the basic principles of successful investing.
- These five charts focus on critical aspects of investing that are insightful in times of market stress: the power of compound interest; don't get blown off by cyclical swings; the roller coaster of investor emotion; the wall of worry; & market timing is hard.

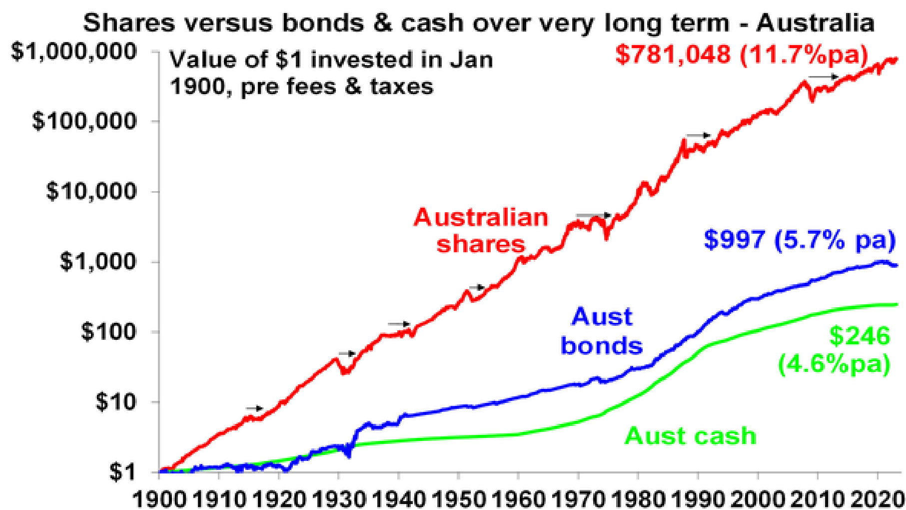
Introduction

Every so often the degree of uncertainty around investment markets surges and that's been the case for more than a year now reflecting the combination of high inflation, rapid interest rate hikes, the high and rising risk of recession which has been added to in the last few weeks by problems in US and European banks. And all of this has been against the background of increased geopolitical uncertainties. Falls in the value of share markets and other investments can be stressful as no one wants to see their wealth decline. And so when uncertainty is high a natural inclination is to retreat to perceived safety. As always, turmoil around investment markets is being met with much prognostication, some of which is enlightening but much is just noise. I will be the first to admit that my crystal ball is even hazier than normal in times like the present. As the US economist JK Galbraith once said "there are two types of economists – those that don't know and those that don't know they don't know." And this is certainly an environment where we need to be humble.

But while history does not repeat as each cycle is different, it does rhyme, in that each cycle has many common characteristics. So, while each cycle is different the basic principles of investing still apply. This note revisits once again five charts which are particularly useful in times of economic and investment market stress.

Chart #1 – The Power of Compounding Returns

This is my favourite chart. It shows the value of $1 invested in various Australian assets in 1900 allowing for the reinvestment of dividends and interest along the way. That $1 would have grown to $246 if invested in cash, to $997 if invested in bonds and to $781,048 if invested in shares up until the end of February. While the average return since 1900 is only double that in shares relative to bonds, the huge difference between the two at the end owes to the impact of compounding - or earning returns on top of returns. So, any interest or return earned in one period is added to the original investment so that it all earns a return in the next period. And so on. I only have Australian residential property data back to 1926 but out of interest it shows (on average!) similar long term compounded returns to shares.

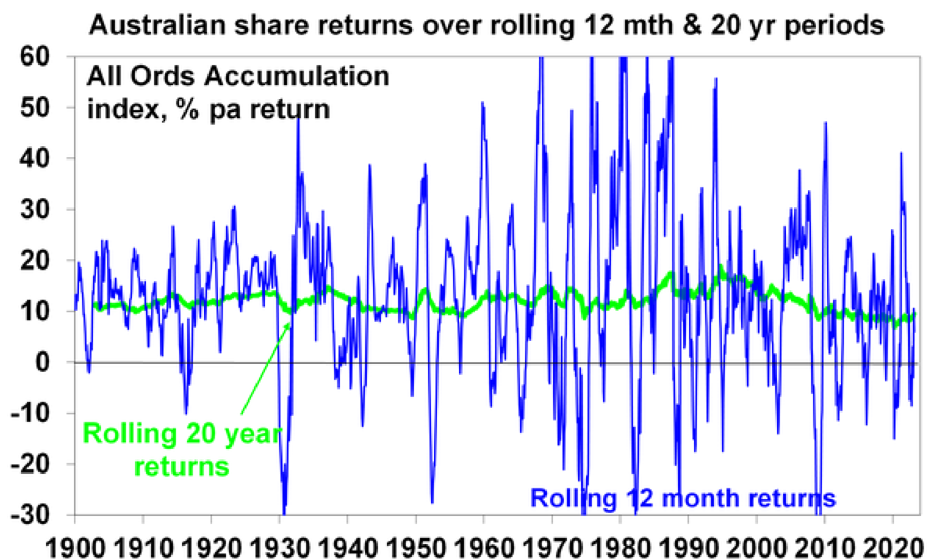


Source: Bloomberg, AMP

Key Message: To grow our wealth, we must have exposure to growth assets like shares and property. While shares and property have had a rough ride over the last year as interest rates surged, history shows that both will likely do well over the long-term.

Chart #2 – Don't Get Blown Off by Cyclical Swings

The trouble is that shares can have lots of (often severe) setbacks along the way as is evident during the periods highlighted by the arrows on the previous chart. Even annual returns in the share market are highly volatile, but longer-term returns tend to be solid and relatively smooth, as can be seen in the next chart. Since 1900, for Australian shares roughly two years out of ten have had negative returns but there are no negative returns over rolling 20-year periods.



Source: Bloomberg, AMP

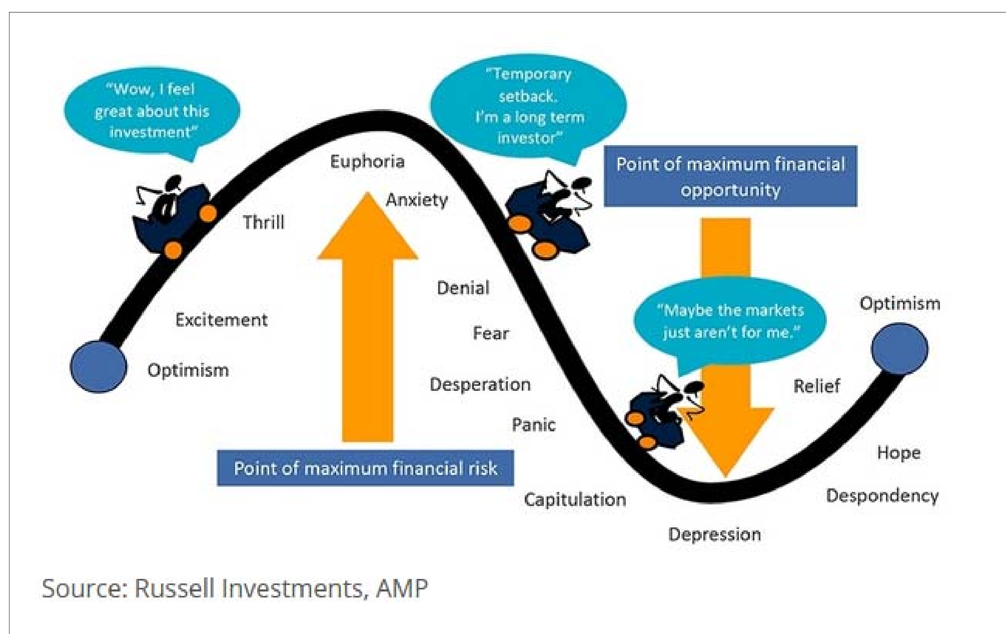
The higher returns that shares produce over time relative to cash and bonds is compensation for the periodic setbacks they have. But understanding that these periodic setbacks are just an inevitable part of investing is important in being able to stay the course and get the benefit of the higher long-term returns shares and other growth assets provide over time.

Key Message: Short-term, sometimes violent swings in share markets are a fact of life but the longer the time horizon, the greater the chance your investments will meet their goals. So, in investing, time is on your side and it's best to invest for the longer term when you can.

Chart #3 – The Roller Coaster of Investor Emotion

It's well known that the swings in investment markets are more than can be justified by moves in investment fundamentals alone - like profits, dividends, rents and interest rates. This is because investor emotion plays a huge part. This has been more than evident over the last year with all the swings in markets. The next chart shows the roller coaster that investor emotion traces through the course of an investment cycle. Once a cycle turns down in a bear market, euphoria gives way to anxiety, denial, capitulation and ultimately depression at which point the asset class is under loved and undervalued and everyone who is going to sell has – and it becomes vulnerable to good (or less bad) news. This is the point of maximum opportunity. Once the cycle turns up again, depression gives way to hope and optimism before eventually seeing euphoria again.

The roller coaster of investor emotion



Key Message: Investor emotion plays a huge role in magnifying the swings in investment markets. The key for investors is not to get sucked into this emotional roller coaster. Of course, doing this is easier said than done, which is why many investors end up getting wrong footed by the investment cycle.

Chart #4 – The Wall of Worry

There is **always** something for investors to worry about. And in a world where social media is competing intensely with old media it all seems more magnified and worrying. This is very evident again now in relation to uncertainty about inflation, interest rates and associated recessions risks. The global economy has had plenty of worries over the last century, but it got over them with Australian shares returning 11.7% per annum since 1900, with a broad rising trend in the All Ords price index as

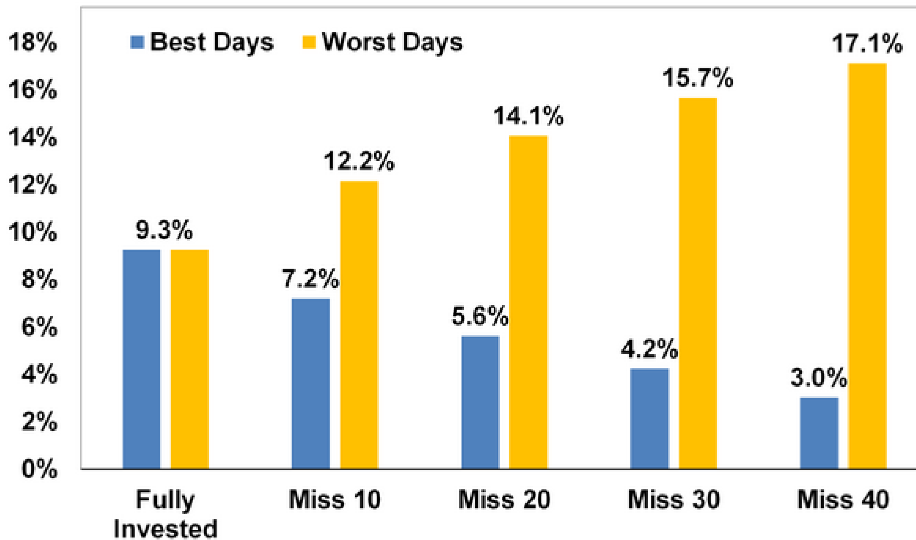
can be seen in the next chart, and US shares returning 9.9% pa. (Note that this chart shows the All Ords share price index whereas the first chart shows the value of $1 invested in the All Ords accumulation index, which allows for changes in share prices and dividends.)

Key message: worries are normal around the economy and investments and sometimes they become intense – like now. But they eventually pass.

Source: ASX, AMP

Chart #5 – Timing is Hard

The temptation to try to time moving in and out of markets is immense. With the wonderful benefit of hindsight, many swings in markets like the tech boom and bust and the GFC look inevitable and hence forecastable and so it's natural to think why not switch between say cash and shares within your investment or super portfolio, to anticipate market moves. This is particularly the case in times of emotional stress like now when much of the news around inflation, interest rates and recession risks seem bad. Fair enough if you have a process and put the effort in. But without a tried and tested market timing process, trying to time the market is <u>very</u> difficult. A good way to demonstrate this is with a comparison of returns if an investor is fully invested in shares versus missing out on the best (or worst) days. The next chart shows that if you were fully invested in Australian shares from January 1995, you would have returned 9.3% pa (with dividends but not allowing for franking credits, tax and fees).



Covers Jan 1995 to 17 March 2020. Source: Bloomberg, AMP

If by trying to time the market you avoided the 10 worst days (yellow bars), you would have boosted your return to 12.2% pa. And if you avoided the 40 worst days, it would have been boosted to 17.1% pa! But this is very hard, and many investors only get out after the bad returns have occurred, just in time to miss some of the best days. For example, if by trying to time the market you miss the 10 best days (blue bars), the return falls to 7.2% pa. If you miss the 40 best days, it drops to just 3% pa.

Key Message: Trying to time the share market - or any market - is not easy. For most it's best to stick to an appropriate, well thought out long term investment strategy.

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