



**This month Richard Champion takes the long view but admits that at times it can be difficult. However we can learn from history . . .**

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**Interesting Times**

It's hard work at the moment trying to put a positive spin on the equity market. This was particularly brought home to me recently as I was talking things over with a client and his IFA. It was in the middle of July, shares were in the midst of an especially savage sell-off and the mood was very downbeat. As is often the case, as soon as the FTSE heads downwards investment managers start talking about "the long term", and there I was doing just that, blathering on about the superior returns over time that equities provide and frankly feeling a bit of a charlatan.

Quite rightly, the client pulled me up.

"Hang on a moment", he said. "Just how long is 'long term'? I mean to say, I handed over my UK equity portfolio to you in 1997 when the FTSE 100 index stood at 6150, and here we are today and it's at 5200. That's a return of minus 15% in ten years and by my book ten years is a long time." He paused for effect and looked me in the eye. "After all, wasn't it Keynes who said that the long run is a misleading guide to current affairs and that in the long run we are all dead?"

Inwardly I grimaced. There are few things more depressing in life than to be absolutely certain of the appropriateness of a given course of action, only then to be inconvenienced by the facts.

"Well," I replied, "you are perfectly correct that the headline number for the FTSE 100 has done less than nothing at all over the last decade. However, we really

need to look at the total return figure, with dividend income added back in. On this basis, the index has risen by 14%. Granted, that represents a paltry 1.3% compound annual return, but it is better than nothing."

"Better than nothing," retorted my client, "but not than what I could have received, pretty much risk-free, from leaving it on deposit in my local building society."

Two-nil to the client. Indeed, had he wanted, he could have pressed home his attack by asking me to calculate real returns to take away the impact of inflation. But he was too kind to do so and despite his disappointment he remains commendably attached to the (very) long term outperformance of equities over other asset classes.



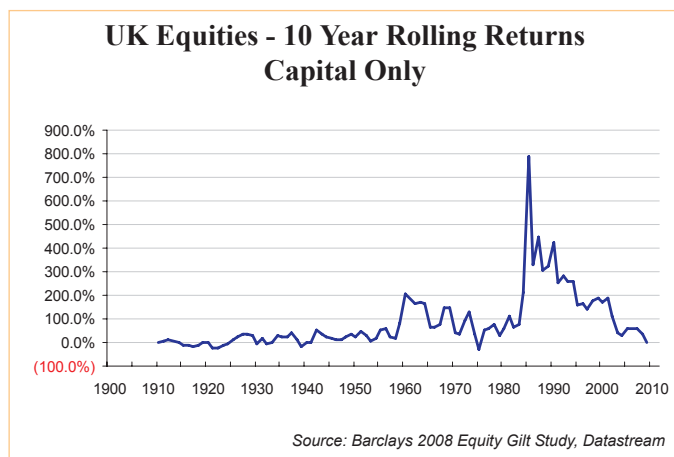
## Tough Times for Equities

The exchange got me thinking, however. How many times over the last 100 years or so have UK equities given a negative return over ten years? How long do these periods last? What lessons can we draw from them? Just as importantly, what have the equity market returns for the ten years after such events been?

The obvious source for this exercise is the Barclays Equity Gilt Study (BEGS), which provides data for the UK dating back to 1899, in capital only, total return and inflation-adjusted terms.

Let's start with the headline number, as cited to me by the client above. Figure 1 shows the ten-year rolling return on the UK market as calculated by the BEGS. (This is based on the broader UK market, rather than the FTSE 100 data quoted above.) It is in fact very unusual for negative returns over ten years in nominal terms. Only in 1974 has this been the case since the end of the Second World War. Today, with continuing equity market turbulence, we stand on the very threshold of this occurring again. A fall of only around 2% by the end of the year would be enough. It is also quite possible, of course, that by the year-end the market may have recovered enough to avoid this fate.

Figure 1



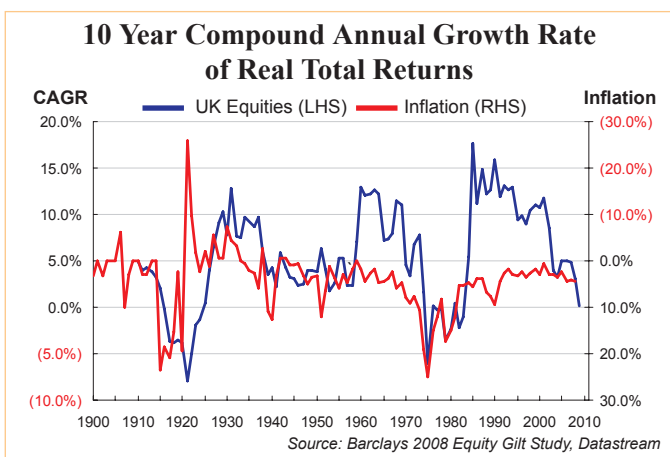
The only consistent period of negative ten-year returns on this basis was between 1914 and 1923, a period marked by war and resultant inflation and thereafter by a sharp deflation. Interestingly, ten-year returns were negative only twice in the 1930s (1931 and 1938), which gives ample evidence of the relative success of the UK's abandonment of the Gold Standard in 1931 in combating the great depression.

However, as I noted above, nominal returns only give part of the story, even if it is the part most likely to catch the headlines on the television news. Dividend income and inflation must be taken into account to obtain the

real return, which is the accurate and proper measure against which to measure performance.

In figure 2 I have included both the ten-year rolling return (in blue, left hand scale) and the annual percentage inflation rate (in red, right hand scale, inverted). The data is given at the absolute level and expressed as the ten-year compound annual growth rate of total, inflation-adjusted returns.

Figure 2



The picture now is rather different. It is immediately clear that today we stand on the cusp of an especially rare position. In only two previous periods over the last 100 years have real total returns over ten years been negative. Between 1915 and 1923 there were nine consecutive negative numbers. Then between 1974 and 1982 there were seven years out of nine of negative ten-year returns, with only 1975 and 1980 remaining positive. A tiny move down from here by the end of 2008 would put us back into this negative position.

## Are the Fundamentals Different Now?

In both these instances the defining characteristic of the underlying economic period was high inflation. In the first case this was a result of the monetary relaxation required to finance the First World War, followed shortly afterwards in the early 1920s by a sharp period of deflation. In the second it reflected successive oil and balance of payments crises, the dislocation of the global Bretton Woods monetary system and negative real interest rates. This period culminated in the UK being forced to apply to the IMF for an emergency loan. It is interesting that in both cases inflation (or deflation) acts as a coincident indicator of troughs in long term equity returns.

A second defining characteristic of previous periods has been geo-political turbulence. Although we are 'at war' with terror, I would suggest the situation today is considerably calmer than it was in the mid- 1970s and

certainly than in the second decade of the last century. It is noteworthy that during the Second World War ten-year real returns did not turn negative, despite a period of relatively high inflation.

One characteristic that the current period does share with the mid-1970s is a preceding period of extreme financial speculation, an excess of leverage and a consequent banking crisis. It could even be argued that some of the effects from the Great Wall Street Panic of 1907 were still lingering in the 1913 period (ironically the US Federal Reserve was founded in 1913), but the effect of the slide towards European war was undoubtedly a far bigger consideration.

It is both concerning and fascinating that we are entering negative territory for only the third time in 100 years. However, we are doing this with inflation of close to 5% rather than nearer to 20%, positive (but only just so) real interest rates and with a calmer geopolitical situation, but with a systemic banking crisis in full swing and the unwinding of several years of accumulated leverage in prospect.

So where do we go from here? Equity market returns over the two previous occasions when ten-year returns fell below zero provide a starting point. Between 1915 and 1925 the market rose by 47.3% in real terms, compound annual growth of 3.9%. Between 1920 and 1925 the return was a more appealing 165%, or 21.5% per year. More spectacularly, given its duration, between 1974 and 1984 the market rallied by 407%, compound growth of 17.6%.

## Conclusion

This is not to say the market may not get cheaper from here; in the 1915-25 period the low came in 1920. In the 1974 to 1984 period, of course, 1974 was the low, following as it did a disastrous 1973.



On the two previous occasions when UK equities have suffered similar periods of poor performance, the duration of rolling ten-year negative returns tended to be quite extended. However, it would be surprising were this to happen on this occasion; firstly, as the 'high' years of 1998 and 1999 work their way out of the figures, the comparative data become rapidly more beneficial for market returns. Secondly, we are coming off a much lower level of background inflation. Thirdly valuations remain attractive, with especially strong backing from the dividend yield. Finally the global economic and geopolitical situation is far more supportive of growth in corporate earnings in the medium term.

To get things moving forward from here we really need to see lower inflation and interest rates, the prospect of a resumption in sustainable economic growth, a recovery in the outlook for the Western consumer and a recovery of confidence and credit-worthiness. We would expect the first two requirements to be in place by the early part of 2009; however, a resumption in economic growth and a recovery in the Western consumer may take longer to occur.

So although the glass is only half full, the lesson from the past is that it is dangerous to abandon equities after a sustained period of underperformance, both against their own history and against other asset classes. Ultimately their long term fundamentals tend to reassert themselves.

But there I am again, rabbitting on about the long term. It's hard to stop sometimes!



# MARKET LEVELS AND MOVEMENTS TO 31 AUGUST 2008

## UK Equities

	Index	vs Last Month %	YTD %
FTSE 100	5,636.61	4.2	-12.7
FTSE 250	9,381.84	5.9	-12.0
FTSE SmallCap	2,848.48	3.4	-16.7
FTSE All Share	2,868.69	4.4	-12.7

## Overseas Equities

	Index	vs Last Month %	YTD %	YTD (£) %
US (Dow Jones)	11,543.55	1.5	-13.0	-5.0
Europe*	167.78	0.2	-21.6	-13.6
Japan (Nikkei)	13,072.87	-2.3	-14.6	-4.1
Pacific*	328.90	-2.4	-23.6	-19.6

\*based on FTSE All-World Indices Europe ex UK and Pacific ex Japan respectively

## UK Valuation Yardsticks

Market P/E	12.2	(historic, FTSE All Share)
Index Linked Yield	0.6%	(over 5 years, 5% inflation)
Market Yield	4.0%	(net historic, FTSE All Share)
Base Rate	5.0%	

## Bond Yields

	Now %	End 2007 %
UK	4.5	4.5
US	3.8	4.0
Germany	4.2	4.3
Japan	1.4	1.5

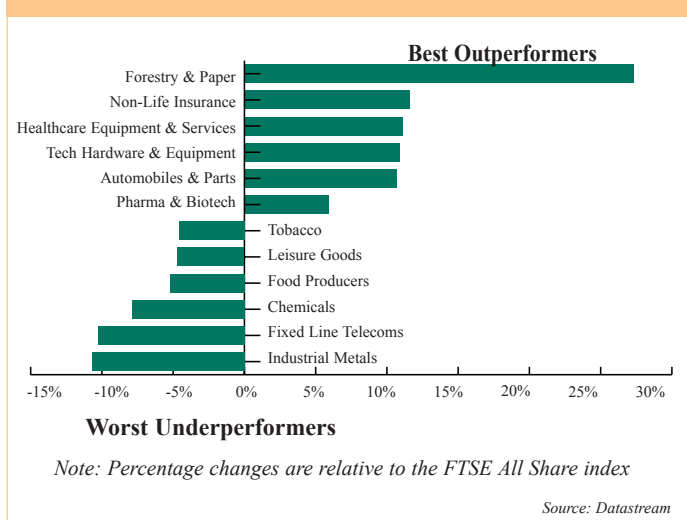
(based on ten year Government bonds)

## Currencies

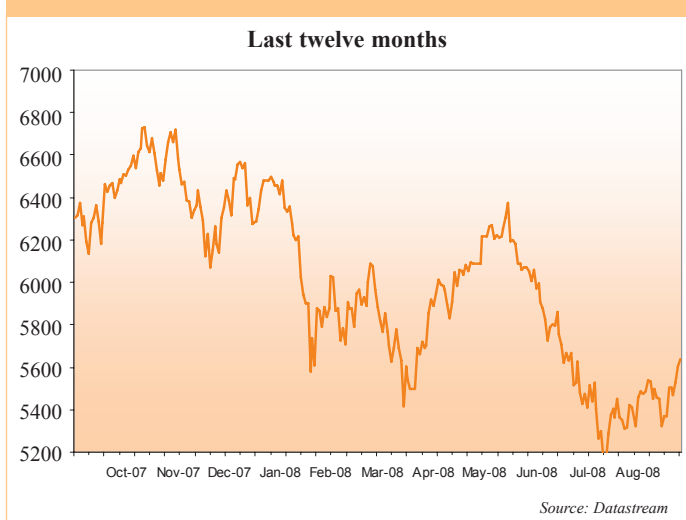
	Current Rate	YTD %
£ vs US\$	1.8	-8.4
£ vs Euro	1.2	-9.0
£ vs Yen	197.9	-11.0

Source: Datastream

## Sectors of the Month



## FTSE 100 Index



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