

2009: The Year of Equities

2009 will be the year to remain in, and where possible to increase, your client's exposure to Aussie equities. We're not predicting an immediate share market recovery, but this statement reflects the fundamental rationale for share investing – access to the long-term wealth creation mechanism that “sharing” in corporate profits provides.

In this short note we refocus on three key aspects of investing – your practice will prosper next year if you think through these while you are at the beach over the break:

- Why there is an equity risk premium and what it means for investors when the equity risk premium rises (especially in market panics like we have seen this year);
- Why shares are like investment properties, in their capacity to deliver growing streams of income over time irrespective of short term fluctuations in their price;
- Why investors and advisers should consider shares just like any other asset – we should buy them when they are cheap and sell them (if needed) only when they are overpriced.

One of the delights of the last 6 months for me has been a re-acquaintance with US cable news channels, and in particular CNBC Squawk Box and Bloomberg TV. Why?

Simply because it's been possible to see and hear the policy makers and market participants in real time, with detailed financial analysis and not simply the tabloid noise that typifies Australian financial journalism. Seeing the likes of Bernanke, Paulson and the playing out of the TARP saga in real time gives a very good feel for the reality of this market panic that we have just lived through – it's obviously the biggest event of our financial lifetimes.

But – as CNBC anchor Joe Kiernan said recently, if these were any other assets, we'd be buying shares now as much as we could.

Planners – come out of hiding to prosper in 2009!

The reality is that most planners and clients are in hiding, fearing that buying shares at these prices may be a sucker trap for the unwary. The best advisers and clients are actively rebuilding their investment portfolios RIGHT NOW – and these will be the practices that prosper in 2009. Aussie equities provide the best longer term return of any Aussie financial asset class – this is borne out by the ASX/Frank Russell “Long Term Investing” reports which show that shares beat even residential property as the best performing asset.

The longer we stay in the share market, the less volatile will our investment performance be. That's fairly standard stuff for planners, but what is often missed is that shares that are bought and sold in a less than 1 year timeframe always exhibit massive swings between positive and negative returns.

The irony is that the dominant form of investment vehicle, the benchmark aware managed fund, turns over most of its portfolio in a less than 12 months period – directly exposing investors to wild swings in value and unnecessary levels of volatility.

The equity risk premium will be your friend in 2009

One of my favourite articles was written by Arun Abey in 2003 and its opening sentence is still relevant today: “Few things in this bear market have caused more confusion than the equity risk premium, and the research community itself is split three ways.” The article gives us a very clear message about why we should buy shares, even when they are trading at depressed prices:

“In a market based society, wealth is generated through the company structure. Apart from building your own business, owning shares is the only meaningful way to participate in the long term growth in companies and the economy....in a market based society, companies that are expected to produce lower returns than risk free bank deposits eventually fail...Only quality companies survive for the very long term...

Because this “creative destruction” directs funds to companies that make money, investors can be pretty sure that an equity risk premium will be there over the very long term in a successful market based society...

Over the average investor’s lifetime, the equity risk premium will almost certainly be there and should be generous. Only those who invest in equities consistently will capture the full reward with any reliability.” (Abey A, IFA, March 2003, my emphasis added).

There is a lot to be recommended by this approach. It is a key to building wealth for your clients (and it makes a mockery of the asset consultant’s who are calling for clients to redirect funds to bond funds in the next 12 months, apparently because of the perceived weakness in share earnings in 2009. Planners don’t recommend shares to clients based on 1 year earnings, they should recommend based on value and earnings over the investor’s life cycle).

Shares should be treated like investment properties – yield first, capital growth second

When I deliver training to planners we have the opportunity to reflect on successful property investors – most of us know landlords who are living off the rent of properties purchased many years ago. It’s the same for shares – the yield on NAB shares purchased in 1990 is, in today’s terms, approaching 50% pa based on the initial cost of those shares. There is nothing more certain than the gratitude a client will show you for setting them up with assets that yield them these levels in their retirement. Even if dividends are under pressure in the near term, they can and will grow over time (for quality stocks that is, remember that we do advocate some level of active management so that you can get rid of bad performers over time).

So this makes a mockery of the broker calls recently to sell a stock like CBA, on the basis that CBA profits in 2009 may fall by 17% and that dividends may be cut by up to 10%. CBA is yielding well above 6% pa at current prices and a reduced dividend to say 5% means that on an after tax basis buying CBA with borrowed money is nearly positively geared. Think about this – it means that your clients get paid to wait by buying and holding CBA shares until the companies fortunes improve...and for those who have seen how the banks fare over the medium to long term, its pretty clear that CBA and the other Aussie banks can and will recover! Seeing the CBA share price at current levels is a classic example of letting the equity risk premium work for you and your clients.

Buy shares when they are cheap, not expensive

Why can’t we and our clients think about shares like other assets? Maybe because of the liquidity and daily price movements, coupled with (to many) the apparent inexplicability of the share market gyrations. It’s our job to understand and react to share value fundamentals. We have to learn to ignore the broker recommendations to sell stocks for short term profit – unlike the Cockney “barrow boys” of the London stock jobbing market, our clients should buy and hold shares for as long as their fortunes permit. So its our job to remove sentiment from the client’s mindset, and to show them how they can prosper by buying shares in times of weakness, and using their growing income streams to underpin life in retirement.

These are simple messages and I hope that you and your clients will prosper in 2009 by heeding them. The best investors (like Warren Buffett) are buying shares, right now, for the longer term.

Tony Rumble