

Timing depends on the horizon



MARGIN CALL

Nevil Gibson

It's simple – buy low, sell high. But when?

No matter whom you ask, now is never the right “time” to invest in shares.

In an analysis of the global market, Michael Lang, principal and chief investment officer at NZ Funds Management, has picked up the theme that shares may have exhausted their run since March last year.

His historical survey shows that shares rise for two years after an economic crisis – ranging from 20% since the WorldCom default in August 2002 to a 70% gain since the October 2008 global financial meltdown (MSCI local currency performance).

The latter is the largest gain in a series of 10 crises since the Arab oil embargo in December 1973.

Mr Lang says historical price-earnings (p/e) ratios and dividend yields show little future value – but “while the sharemarket may be expensive this does not necessarily mean it is about to head on a downward direction.”

Trend spotting

When analysing data since 1871, clear trends emerge, he says.

“If you invest when price to earnings ratios are low you will achieve higher returns in the following two, five and 10 years than if you invest when p/e ratios are high.

“For example, when p/e ratios are between 4.8 and 10.7 an investors’ average return is 10.5% in 10 years. When p/e ratios are expensive, or between 19.4 and 44.2, then the average return in 10 years is a mere 2.8% (see table I).”

MEDIAN FORWARD REAL RETURN (pa)					
Price to earnings					
Quintile	P/E	Av p/e	2-yr	5-yr	10-yr
1	4.8-10.7	8.6	14.5%	12.5%	10.6%
2	10.7-13.7	12.1	10.2%	7.6%	7.8%
3	13.7-16.6	15.2	5.7%	6.8%	6.4%
4	16.6-19.4	17.9	4.7%	6.0%	5.5%
5	19.4-44.2	24.0	4.3%	2.0%	2.8%

MEDIAN FORWARD REAL RETURN (pa)					
Dividend yield					
Quintile	Div yld	Av div yld	2-yr	5-yr	10-yr
1	5.8-13.8%	7.0%	14.4%	12.9%	10.9%
2	5.0-5.8%	5.4%	7.5%	7.4%	7.7%
3	4.2-5.0%	4.6	6.8%	6.0%	7.0%
4	3.4-4.2%	3.8%	3.4%	3.9%	5.6%
5	1.2-3.4%	2.8%	5.2%	5.0%	4.3%

Source: NZ Funds Management (based on Robert Shiller's data, which use rolling average 10-year reported earnings)

(Currently, p/e ratios of global shares in the US are averaging in the upper range.)

Similarly, when dividend yields are high, you will receive a higher return in two, five and 10 years than if you invested when dividend yields are low.

Investing when dividend yields average 5.8-13.8% will provide a healthy 10.9% in 10 years. But if yields are 1.2-3.4%, then the average return on global shares is likely to be just 2.8% (see table II).

“With yields running at a low in the 1.2-3.4% range, investors can

expect muted return if investing in global shares now,” Mr Lang says.

Bucking the trends

This week, global markets showed how unpredictable they can be. After rising more than 7% in July after a late-month run, Wall Street surged another 2% on Monday but fell back the next day.

“It is quite possible the sharemarket could continue to rise, causing the market to become even more expensive. Currently the price to earnings of global shares are sitting at the same values they were

in 1995... [when they] continued to increase for the five years until peaking at 44 toward the end of 1999, the highest level ever reached.

“While this is not expected to happen now, it does demonstrate that sharemarkets can become significantly more expensive than their current level, and they can remain expensive for extended periods of time, in this case five years.”

Hang in there

Mr Lang says this means it would be a mistake to exit the sharemarket altogether.

“Investors who sell up often forget to get back in and miss out of the long-term ability of global shares to significantly compound their wealth.”

He then goes on to recommend other investment strategies, such as commodities and bonds, though these, like shares, can also undergo long periods of low performance.

Rather than try to “time” an exit, Mr Lang urges use of all three asset classes and hedging to guard against sudden corrections – thus enabling investors to get the benefit of holding for the long term while providing some degree of protection during inevitable (but unforecastable) down trends.

“They should also consider setting aside sufficient funds in cash and hedged investment grade bonds so that they need not sell their growth assets until they have made significant gains.”

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