

300 Years of Investing

Issue 86: May 2019

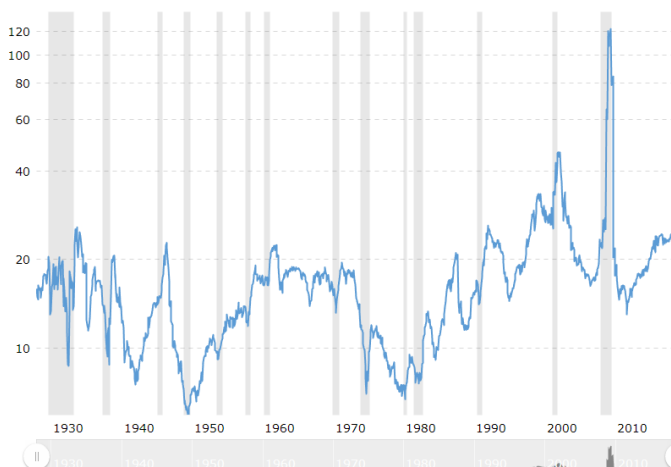
In layman's terms, investors do what they do, because they want to end up with more money. How one would specifically define that objective, depends on each investor – not all of whom are rational.

The best definition of successful long-term investing is probably increasing wealth in **real terms, i.e. a return higher than inflation**, which leaves the investor with an increase in purchasing power. Furthermore, when acquiring an asset, the key driver of its value is its potential to distribute cash flows (dividends, interest or rental distributions and proceeds on sale) to the owner. Investments are made on a spectrum of risk or volatility:

- On the one end of the spectrum returns over the longer term are higher, but with higher fluctuation (volatility) such as shares in listed companies, or private equity;
- On the other side (over the same term) returns are lower, but with lesser volatility e.g. interest-bearing investments such as bonds or money market instruments.

We call the allocation or spread amongst these types of instruments an asset allocation strategy. The **earnings growth of equity shares provides for dividend growth** and/ or for the reinvestment of retained earnings in order to achieve compound growth of the initial investment or capital value.

Investors use a variety of tools to assist them in making financial decisions. Although past performance is not a guarantee for future performance, historical data points and statistics are important inputs in making sound decisions. Below are graphic representations that provide valuable insights for financial investment strategies. Consider the 90-year history of the S&P500 and its Price-to-Earnings (P/E) ratios:



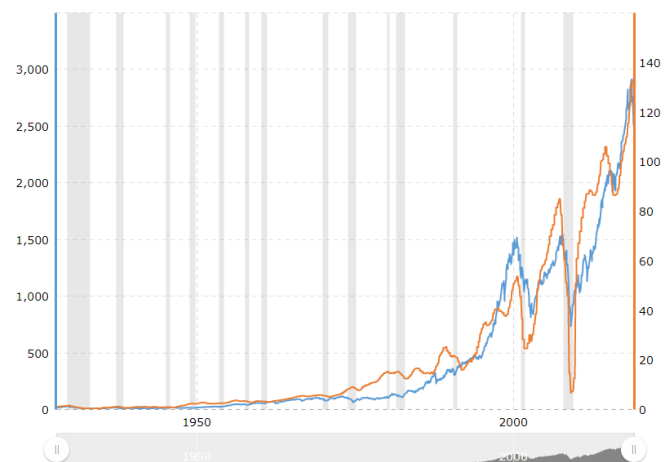
Source: www.macrotrends.net

The S&P500 as a broad US market index

The S&P500 index is widely used to illustrate the broader market performance within the United States of America (US). The index is a quasi-

barometer. The Price/Earnings (P/E) ratio is a figure that indicates the price paid for earnings (return) of an equity investment. A high PE ratio indicates an expensive market and visa versa. The significant fluctuations in the values show the degree of volatility in financial markets. As a result exceptional opportunities for **entry**, or profit taking present themselves at times.

It is important to note that regardless of the variation in PE ratios, they tend to revert to the mean over a long period – an average over several decades. **It follows that a stock market without earnings growth is less likely to retain purchasing power for the investor.** Below is the S&P500 graph that compares earnings to the index value, or level.



Source: www.macrotrends.net

In this graph, the S&P500 index (a market price level) on the left vertical axis is compared with earnings level on the right vertical axis over time. **From these data points we observe that US stock market levels follow earnings diligently.** South Africa and other financial markets behave in a similar manner.

Passive investment in “risk” assets is best rewarded in countries where economic growth potential is attractive. In the short run, there is no direct correlation between economic growth and market performance (it relies on the earnings growth). However, over the long run economic growth is a key driver of earnings growth within a country. Countries that do well economically are generally also well placed for interest bearing instruments. They achieve relatively higher real interest rates. Such countries have stronger currencies and also tend to have stable monetary regimes and governments that allow small and private business to operate freely.

The US is one of the most attractive places for investors. For a moment, let's focus on its monetary regime. The US Dollar is the world's major reserve currency and widely used among trading countries. That implies a demand for its

300 Years of Investing

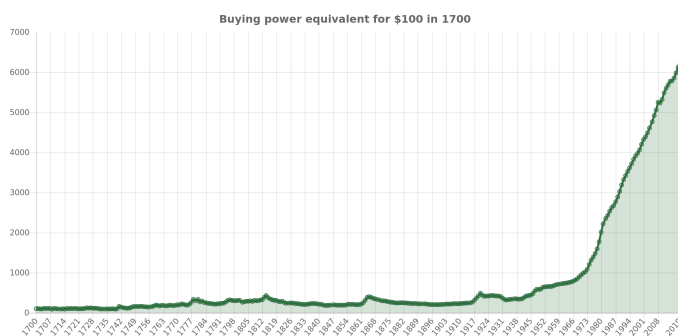
government securities (bills, notes and bonds). It holds a special status and can probably get away with some laxness in its monetary policy management. The US monetary history of the last three centuries can be split into three phases, which roughly corresponds with what occurred elsewhere in the world:

1. *Period 1* – characterised by the gold standard – up to the time around the Great Depression of 1933;
2. *Period 2* – from the 1930s to the early 1970s with a hybrid gold standard and fixed exchange rates;
3. *Period 3* – from the early 1970s to the present – the era of so-called “*fiat money*”. There is no intrinsic value other than, a value guaranteed by the issuing government.

From the charts below, inflation in the US behaved very differently during those periods. During Period 1 there were times of inflation (generally when the government needed money to finance wars) and deflation, but overall the gold standard kept governments accountable.

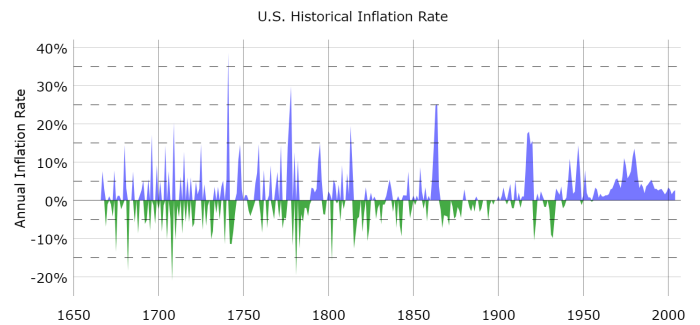
Period 2, during which only a partial gold standard was followed, inflation accelerated and deflation disappeared.

Period 3, after the total abandonment of the gold standard, inflation in the US accelerated significantly. Although inflation is now under control, worries about deflation (the decrease in asset prices) have moved the US Federal Reserve Bank to unprecedented action (with lower effective interest rates). From these multi-decade timeframes, **there appears to be a golden thread whereby governments and monetary systems encourage inflation.** This in itself holds risks for portfolios where there might be a disproportionate allocation to interest-bearing instruments.



Source: www.investopaedia.com

The following graph shows inflation (blue) since 1650 (blue) and deflation (green).



Source: www.innovativewealth.com

Due to high debt levels and an environment of sustained deflation is simply unacceptable to any government. Therefore, in the “paper money” era, there is no reason to expect any government to tolerate deflation.

In conclusion

The US can be considered the cradle of modern capitalism. There is still plenty of room for economic growth. It is self-reliant on energy, food, military power and many other things. It has the largest and strongest economy in the world. However, since the 1970s it has accelerated the debasement and eroding the value of its currency that forced investors to own risk assets with the objective to maintain buying power. In this case the US is not alone...

Despite many challenges from left-wing extremists, inappropriate government intervention and too strong labour unions, South Africa remains a capitalist country. The temptation for African countries during hard times has always been to weaken their currency to achieve its political goals. South Africa is no different.

Owning assets that will protect an investor against a loss of purchasing power is essential. Acquiring them in the most tax efficient manner and sticking with a financial plan throughout periods of market volatility, remain vital. As for South Africans, ensuring a healthy chunk of exposure to foreign assets in favourable jurisdictions has become an absolute necessity.