SENECA INVESTMENT MANAGERS

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Peter Elston: Investment Letter

- **Fear of Equities**
- **Asset Allocation and Unemployment**

This document is intended for professional investors only

Fear of Equities

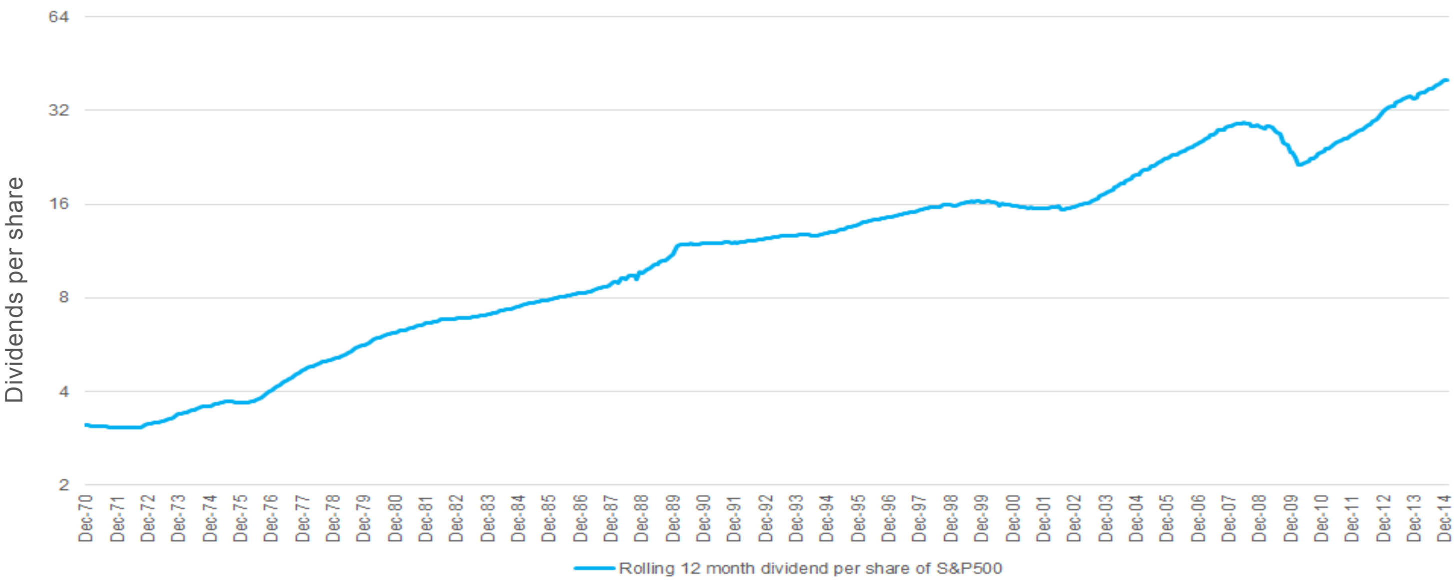
Every now and again I feel the need to wonder why people are so scared of equities, in light of how stable dividend distributions are over time. I'm not the first to wonder this. Thousands before me have written about the so-called "equity risk premium puzzle", a reference to equities returning so much more than they should have, given their risk. Six years into a bull market in equities is perhaps a good time to revisit the question, particularly because I've been meeting a lot of customers recently who have been and continue to be nervous about investing in equities.

The chart below shows the rolling 12 month dividend per share for the S&P 500.
Question: what would you pay for that income stream? (I have used the S&P 500 because data goes back further but you'd see similar patterns in the UK.)

Here are the facts. First, dividend per share growth since 1970 has been 6.0% per annum. Second, volatility of dividend growth has been 6.7% per annum, meaning that two thirds of the time dividend growth has been between -0.7% per annum and 12.7% per annum.

I don't know about you, but I wouldn't demand more than a 7% return from that income stream. Over 30 years, that's 527 percentage points more than you'll get from the 30 year Treasury, which more than compensates you for the higher volatility of the income stream, yes? I think I am being extremely reasonable, although, perhaps a tad greedy.

Rolling 12 Month Dividend Per Share of S&P 500

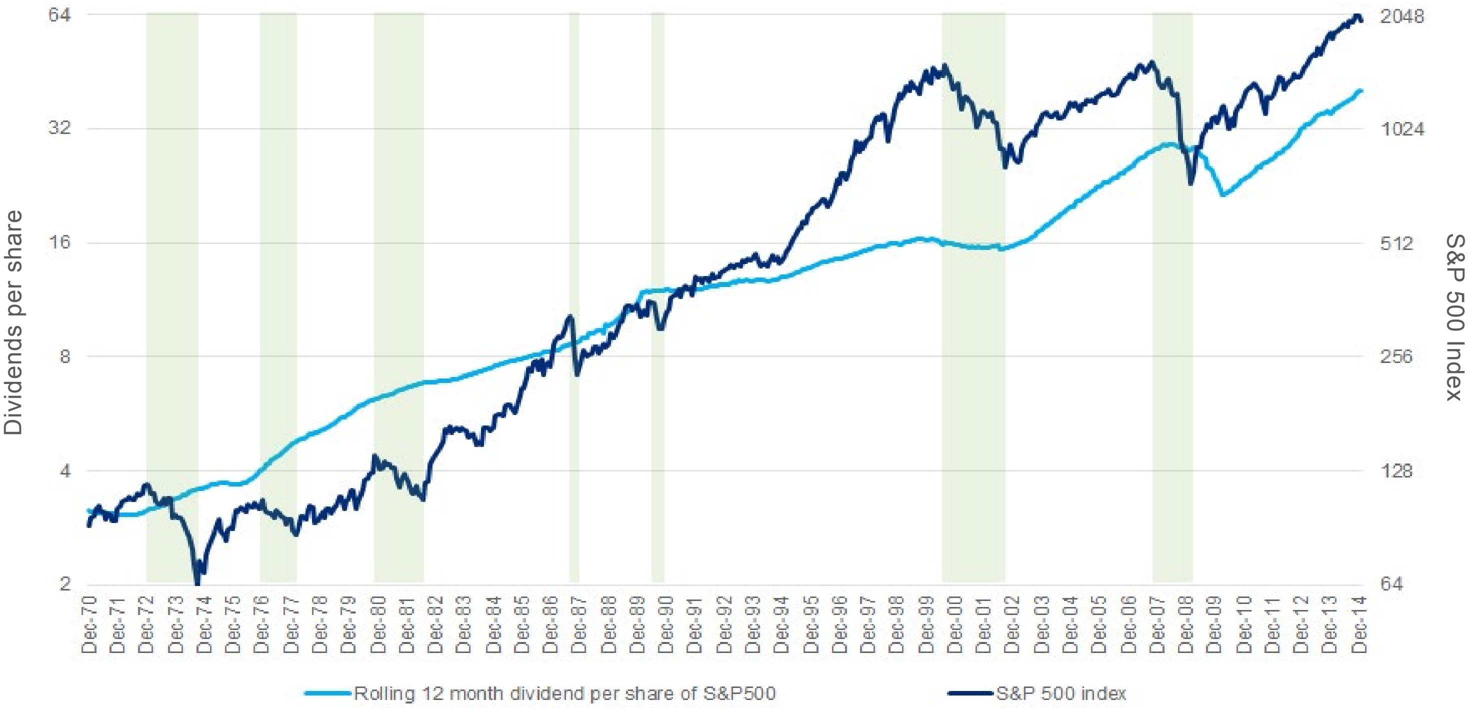


Source: Bloomberg & Seneca Investment Managers as at 30/01/2015

Using the Gordon dividend discount model, a 7% return would suggest a current fair value for the S&P 500 index of 4,151. You'll note of course that I have reversed engineered this result. But I have done so to make a point, namely that even if the S&P 500 index reached 4,151, your return would still be a respectable 7% per annum!

The next chart overlays the dividends per share (left hand scale) with the S&P 500 index itself (right hand scale). It also bands the seven equity bear markets we have had in the last 45 years. The only bear market that was remotely justified on the basis of what happened to dividends was the most recent one in 2008-9. All the others saw no corresponding decline in dividends. Indeed during the first five dividends continued to rise.

Rolling 12 Month Dividend Per Share of S&P 500 vs. S&P 500 Index



Source: Bloomberg & Seneca Investment Managers as at 30/01/2015

But the main point to note is how much more volatile the index is in relation to the underlying dividends. The volatility of the S&P 500 index is 16.7% per annum, 2.5 times that of dividends.

There is an illogical circularity here. Equity investors demand a high return because of equity market volatility, but it is their own behaviour, not that of the underlying dividends, that causes the volatility!

The point of all this of course is twofold. First, one should not be nearly as fearful of equities as is generally the case. Second, bear markets should be welcomed with open arms; they represent opportunities to buy a fabulous income stream super-cheap.

These conclusions have widespread academic support, but a paper written in 1994 by William P. Bengen, Determining withdrawal rates using historical data, is particularly interesting. Bengen's study considered historical returns from equities – and bonds – over the long term to determine optimal equity-bond asset allocation as well as the maximum one could withdraw from one's fund every year – expressed as a percentage of the starting value – without running out of money within 30 years. This maximum percentage he calls Safemax.

Although conventional wisdom is that in retirement one should shift to a more defensive asset allocation strategy, Bengen's study found the opposite was true. He writes, "An asset allocation as high as 75% in stocks during retirement seems to fly in the face of conventional wisdom…But the charts do not lie – they tell their story very plainly." The charts he refers to are ones that clearly show portfolios with higher allocations to equities lasting a lot longer than those with lower allocations. He then goes on to consider how one should react to periods of poor equity market performance, concluding that increasing the equity weight to 100% is the optimal strategy. "This [increasing allocation to stocks following periods of poor performance] is a testament", he says, "to the enormous recovery power of the stock market – and the need to avoid emotion when investing. The best time to invest is likely to be right after the worst time to invest! Admittedly, increasing stock allocation to 100% after a long period of miserable returns requires unusual foresight and fortitude on the part of the adviser, as well as the client. If you can convince your client just to maintain the 75% allocation under such conditions, you have won a major battle. However, the client is still faced with a shorter-than-average portfolio longevity, and with much less wealth to pass on to heirs than originally hoped for."

I would add two points to Bengen's study. First it was written when long-term real interest rates in the US were 4%. This represented good value so an allocation to them made sense. Nowadays, long-term real interest rates are now either close to zero or negative, depending on the country, which makes allocating anything to government bonds an absurd idea. Second, longevity has risen over the last 20 years so one has to make one's portfolio last even longer than was previously the case.

Six years into a bull market it is very hard to move from a defensive to a moderately aggressive stance (if you've been decently weighted in equities the last six years, well done and stick with it!) Bull markets only tend to last eight years, I hear you say, so surely the next bear market is just round the corner. It is possible that the next bear market is indeed about to begin, but it is also possible, probable even, that this is not the case. The current bull market is to a large extent a function of the bear market that preceded it. Since the last one was so damaging, the recovery may well be longer. This suggestion is supported by dividend yields that are, on the whole, still above historic averages so have further to fall. Furthermore, bear markets don't tend to begin until unemployment rates start rising (as this is when central banks start to tighten monetary conditions). Since we're still some way off from this happening, the likelihood is that the bull market has further to run.

But there is a chance that I'm wrong, or that some shock causes markets to fall, so if you are persuaded – as I hope you will be - to increase your equity exposure at these levels, you must also be ready to increase it even further. Contingency plans are after all an important part of any strategy.

Asset Allocation and Unemployment

I am a big believer in keeping tactical asset allocation simple. The more complicated you make it - either by considering too many factors or time frames that are too short – the less effective it tends to be. To support this view I cite work done in 1979 by Richards J. Heuer Jr. involving a study of horse handicappers. The study found that as one increased the number of pieces of information available to the handicappers from one to five, accuracy of predictions increased. However, beyond five pieces, accuracy decreased. Furthermore, while accuracy levelled off beyond five pieces of information, handicappers' confidence in their predictions continued to increase!

My approach to tactical asset allocation focuses, simply, on the business cycle and how different asset classes perform at certain times. This means having a longer term time horizon, because business cycles average around six years.

To gauge the business cycle I use one indicator: the unemployment rate. There is nothing more fundamental to an economy than the percentage of the workforce that it is not, for whatever reason, able to be put to work. Employment is closely linked with economic activity, a major determinant of bond and equity markets, hence my use of it in tactical asset allocation. This of course makes complete sense. Why? Because the unemployment rate is a good measure of inflation pressures and inflation pressures are a good leading indicator of monetary policy, the key driver of financial asset prices.

Of course if one is using the unemployment rate to predict the future path of asset prices, one must first establish that the unemployment rate is itself predictable. A simple way to do this is to determine if there is a sufficiently high correlation between the change in the unemployment rate over one period and the change over the next period. If there were no correlation, this would indicate that the unemployment rate follows a random walk and is thus unpredictable.

It turns out that, at least in the case of the US, changes over four months have the greatest predictive ability (three and five months changes are less correlated than four months). The correlation coefficient between four month changes and subsequent four month changes is 0.54, which indicates a fairly high degree of correlation. If I've lost you, just look at the chart below showing the unemployment rate in the US over the last 70 years and ask yourself whether it looks random or whether it contains some sort of pattern.

US Unemployment Rate

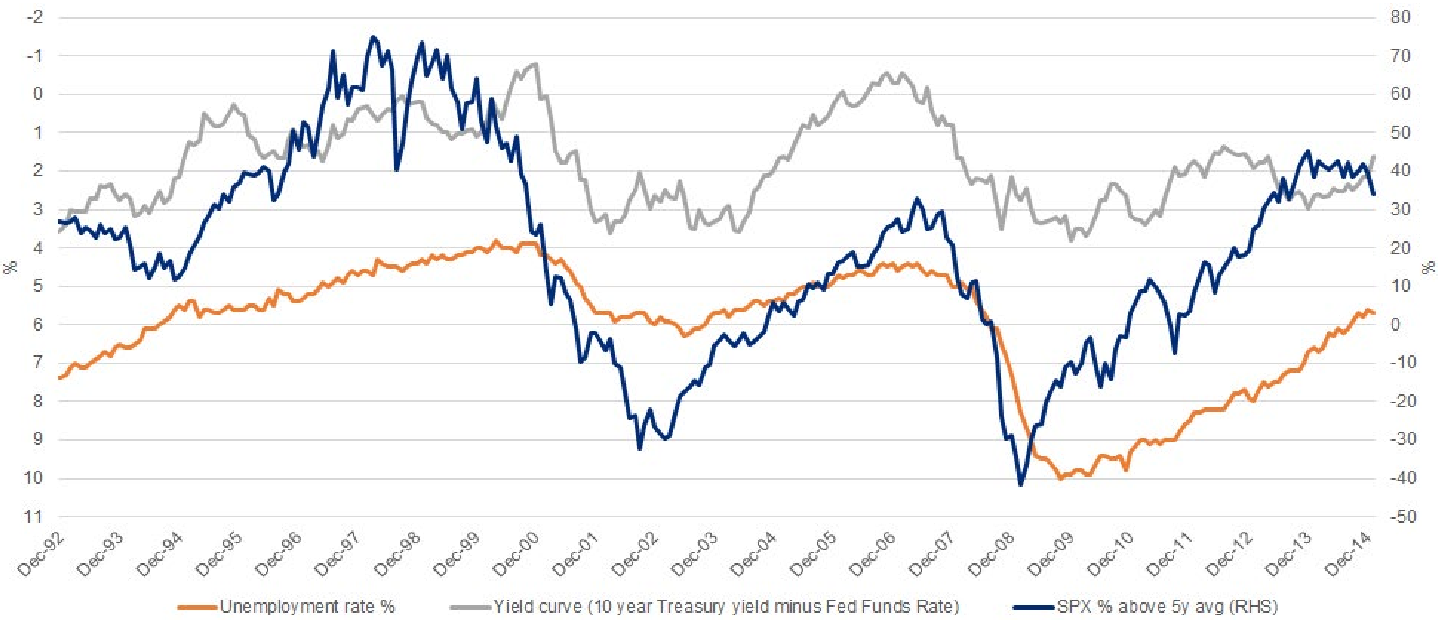
Source: Bloomberg & Seneca Investment Managers as at 30/01/2015

The relationship between the unemployment rate and long-term interest rates is a simple one: inflation. If the unemployment rate is above a certain level, inflation pressures will be low or falling and thus bond prices rising. Similarly, if the labour market is tight, inflation pressures will tend to be high or rising, a not-so-good environment for bonds.

Equities tend to perfom poorly when unemployment is rising, as rising unemployment is a feature of recessions and thus weak corporate profits.

Thus, much of the time, equity and bond markets will be out of sync (negatively correlated). Safe haven bond markets like rising unemployment. Equities do not.

Unemployment Rate, The Yield Curve & The Stock Market



Source: Bloomberg & Seneca Investment Managers as at 30/01/2015

So, what are unemployment rates around the world at the moment saying about the outlook for bonds and equities?

In the case of developed markets, unemployment has fallen pretty much everywhere, the reason for the good performance of equities generally. However, rates remain above levels that would be considered inflationary, so bonds have also been performing well. Looking ahead, the US and the UK are closer to the point at which inflation will start to rise than is the case in Europe and Japan, where unemployment rates remain closer to their peaks than their troughs. So, although equity markets in all four still look well supported, they look best supported in Europe and Japan.

As for bonds, there appears to be very little value in developed sovereign markets, but since inflation pressures are likely to remain most subdued in Europe and Japan, their bonds would be the relatively more attractive, if unappealing in absolute terms.

Of course there will always be noise that causes short-term volatility, but one would be advised to ignore this and look for the pattern. Simple.