Global Troubles

Harold Macmillan was once asked about the most troubling aspect of his Prime Ministership. He famously replied, “Events, my dear boy, events”. Similarly unexpected events, both domestic and international, have long been seen as the bane of investors, particularly when they are seen as presenting significant economic risks. This poses a dilemma for investors - to what extent should they respond to events when managing their portfolios? I believe that, in general, particularly for investors taking a long-term perspective, the greater risk to investment returns comes from overreacting, rather than underreacting, to events. This partly reflects the fact that many events are difficult to predict and when they do occur, or are at risk of occurring, markets respond quickly and reprice assets accordingly. It also reflects the reality that many events ultimately prove to be of limited duration and, often with the help of policy makers, are alleviated over time. Note also that so-called ‘risk free’ assets such as cash, which traditionally have been used as a haven during market volatility, currently offer very poor returns which means holding them for any length of time is likely to see their real value eroded by inflation.

There have been several studies of long-term asset returns. One of the best known is *The Triumph of the Optimists*, written by academics at the London Business School, which analysed returns for the major asset classes in sixteen countries over a 101-year period. The study concluded that, “In every country, equities proved to be the best performing investment over the twentieth century” and, furthermore, that bonds performed poorly as inflation proved, “to be higher and more volatile than expected.” Bond returns were particularly negatively impacted in those countries afflicted by hyperinflation such as Germany in 1922-3. However, even the moderately high inflation of the 1970s also negatively impacted on real bond returns. More generally the study showed that the very worst asset returns, for both equities and bonds, were experienced by investors in those countries that were decimated by wars, revolutions, hyperinflations and/or prolonged periods of economic depression.

Clearly investors should pay attention to the most serious events and particularly those that appear systemic, involve ‘regime change’ and/or are likely to be of an extended duration. Where the long-term risks appear to be skewed in one direction it seems appropriate to tilt the asset mix accordingly. For example, we believe inflation over the next twenty years is likely to be higher than in the previous twenty years and, in 2020, we added an inflation hedge to our portfolios by investing in index-linked bonds. However, investors should also not underestimate the re-equilibration mechanisms that can help to ‘right the ship’ during many crises. A good example of this was provided by the extraordinary fiscal and monetary stimuli that were implemented by the policymaking authorities during the COVID-19 pandemic. These measures reversed the precipitous decline in asset prices that occurred in early 2020 and provided a ‘bridge’ until the scientific efforts to develop a vaccine bore fruit.

Lastly, for equities, investors would do well to remember the adage that, “it is not about timing the market, but time in the market.” One recent calculation by Schroders has shown that, in the 35 years since 1986, missing just the 20 best days for the FTSE All-Share would have resulted in an investment return of 635% compared to 1945% by remaining invested over the whole period. Note that this period covers such important events as the stockmarket crash (1987), the collapse of the Soviet Union (1989-91), the Gulf War (1991), the Asian Financial Crisis (1998), the TMT bubble (2000), the Iraq War (2003), the Financial Crisis (2008-9), the European debt crisis (2010-14) and the COVID-19 pandemic (2020-21).

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