

Long-term investing

2012

An annual paper aiming to give investors the facts about long-term investing in the major investment asset classes.



Long-term investing: An insight

An annual study by Perennial Investment Partners

This is our annual update that gives investors an insight into longer-term returns from various asset classes. It is aimed at helping investors think carefully about their portfolio decisions. Investors should understand their personal time horizons for their various investment portfolios so that sensible, wealth-enhancing decisions can be made. Simplistically, an investor saving for a home deposit in one year's time will be focused on capital preservation, whereas an investor saving for retirement in 30 years' time will place greater importance on capital growth and long-term returns. This paper should be read alongside another Perennial paper, *The Wisdom of Great Investors*, which brings together the principles of investing from some of the world's greatest investors.

A warning on the limitations of this type of study

This paper looks at the core markets, based on market indices, as these markets have long-term data available. This does not mean that investors should ignore newer investment classes, alternative investments or other great opportunistic investment options that will come up in the future. It is important to understand the risk involved in these newer or opportunistic investments and to use these investments to enhance long-term returns without adding too much risk to investment portfolios.

Tax has a significant influence on investors' final returns and is something that should be considered. Although owner-occupied housing, superannuation and capital gains tend to be taxed more lightly than income investments, tax is very specific to the individual and the structures they employ to hold their investments. As such, tax is considered to be outside the scope of this paper and investors should seek tax advice when making investments.

The long-term ended 2011

If ever there was a period to test the generally accepted views on long-term investing, the last few years have certainly done that. By any measure, the dislocation in investment markets caused by the GFC was extreme and one of only three extreme events in investment markets since 1900. There are a couple of important observations here:

- **There were only a very small number of people who predicted the crisis and changed their investment strategy accordingly.**

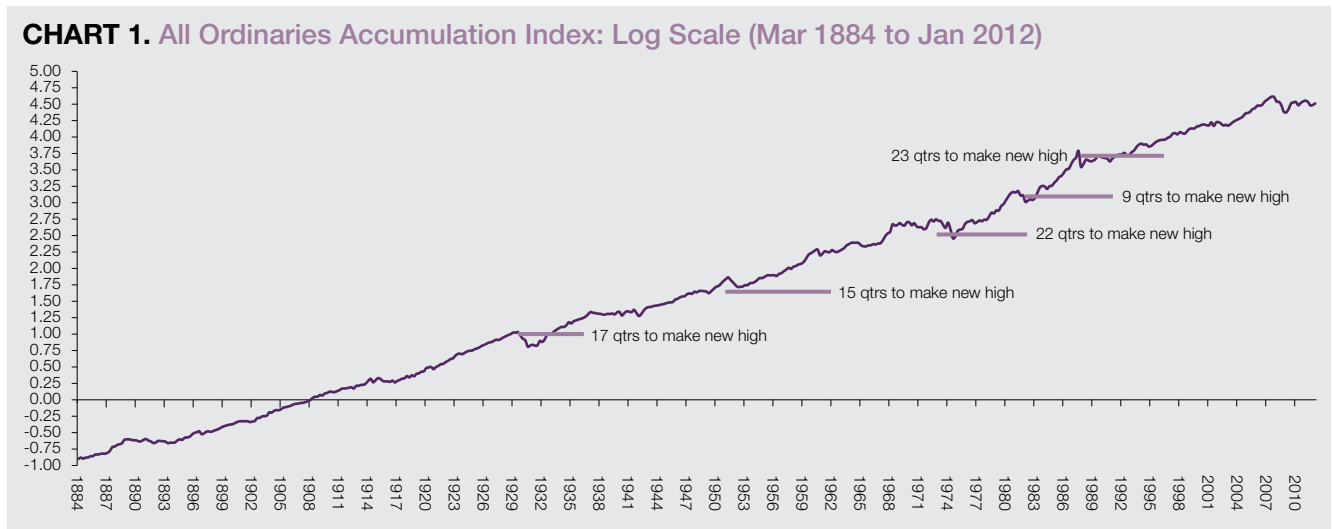
Conclusion: These events are very hard to predict and there will likely be other bubbles and crises that appear out of the blue in our increasingly interconnected world.

- **The challenge that this crisis presented to commonly accepted investment strategies was significant.**

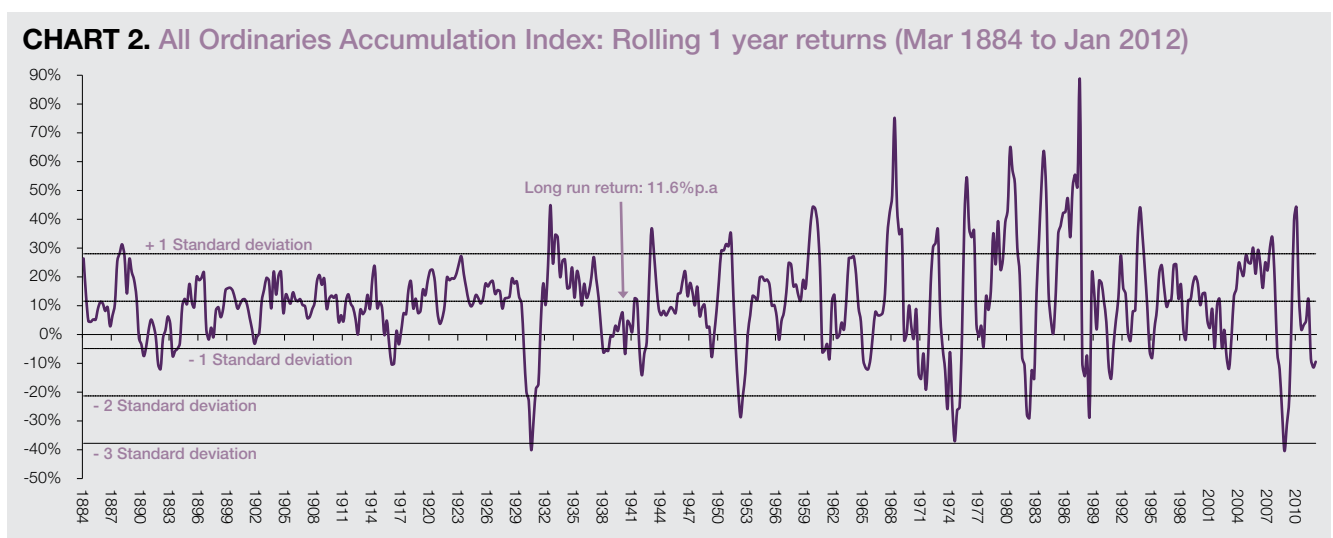
Conclusion: While the jury is still out, as academics and others review the investment aftermath of the GFC, sensible diversification (including an appropriate allocation to defensive assets), combined with regular re-balancing/investment selection review and regular personal needs/goals assessment appears to be the best process for investors to reach their long-term goals.

The long-term: Australian shares

CHART 1 shows a very long-term return series for Australian shares, dating back to 1884. It shows how Australian shares rise and fall in value. However, after every fall the market has tended to recover to reach new highs. Investors should note that this is not true of the sharemarkets of all countries (Japan for instance), but this upward trend typically occurs if a country has a growing economy and positive demographic trends.

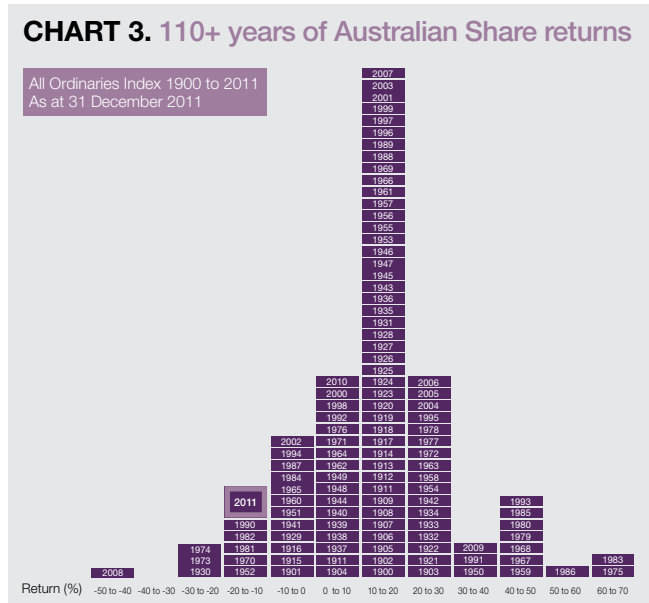


In many ways, these types of long-term charts can be misleading, as they can mask the swings and roundabouts that do occur over shorter timeframes. **CHART 2** looks at the annual returns (measured at the end of each quarter) which investors received over the period 1884 to 2010. As you can see, when viewed on an annual basis, returns have a very wide range. (Investors who are concerned about the range of possible outcomes on a yearly basis should take a look at **CHART 7** on page 6 which gives an overview of sharemarket returns measured every seven years).



Source: Perennial Investment Partners.

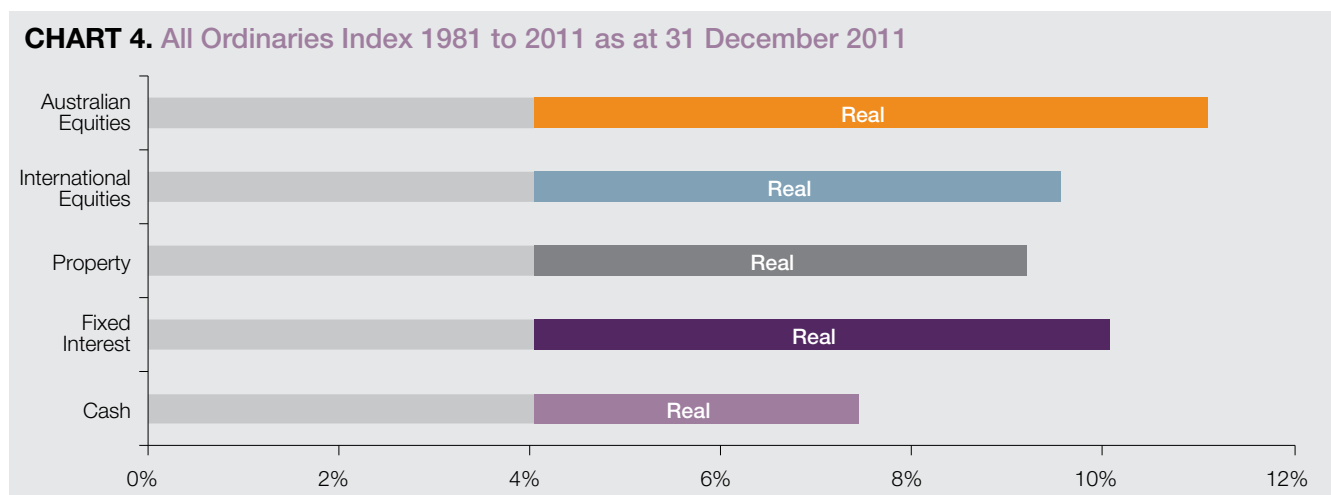
Another interesting way to look at long-term returns is to group annual sharemarket returns into a simple histogram, as shown in **CHART 3**. Similar to **CHART 2**, **CHART 3** shows what an unusual and difficult year 2011 was for investors. It is also worth noting that in many cases poor returns in one calendar year are followed by good returns the year after. For example, 2008 and 2009, 1974 and 1975, as well as 1930 and 1931. While there have been five periods where returns were negative in two consecutive years, there has never been a period of three consecutive negative years.



Source: JP Morgan, Perennial Investment Partners to 31 December 2011.

The long-term: Shares vs defensive asset classes

Unlike the Australian sharemarket, longer-term numbers for investments such as Real Estate Investment Trusts (REITs) and international shares are not available for such long periods. As such, **CHART 4** shows a 30 year time horizon to compare investments. **CHART 4** shows the relative performance of the five traditional asset classes over the 30 year period to 31 December 2011.



Source: Please see Appendix 1.

CHART 4 shows that over the 30 year period to 31 December 2011:

- Australian shares were the strongest performers, providing an annualised return of 11.1% p.a. (or a real return, after allowing for inflation, of 7.0% p.a.¹);
- International shares provided an annualised return of approximately 9.5% p.a. (or a real return of 5.5% p.a.);
- Property provided an annualised return of approximately 9.2% p.a. (or a real return of 5.2% p.a.);
- Fixed interest securities provided an annualised return of approximately 10.1% p.a. (or a real return of 6.0% p.a.); and
- Cash provided an annualised return of approximately 7.4% p.a. (or a real return of 3.4% p.a.).

1. Inflation was calculated using the ABS CPI statistics, catalogue number 6401.0. The latest statistics include up to 1 December 2011. The inflation rate trend between 1 September 2009 and 1 December 2011 was assumed to continue to 31 December 2011.

To put the differences in investment returns into perspective, **TABLE 1** shows the value of \$10,000 invested in the respective asset classes for the 30 years to 31 December 2011.

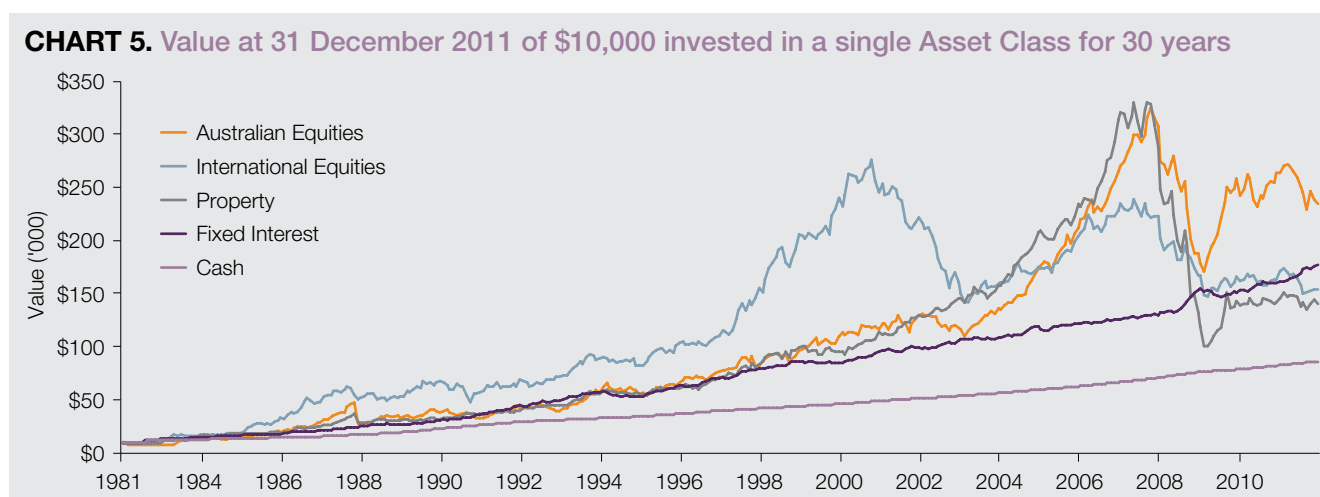
While Australian shares outperformed international shares by a modest sounding 1.6% p.a., looked at on an annual return basis, this results in a large difference in actual investment values when viewed over the longer term. When compounded every year, even relatively small increases in investment returns make substantial differences to long-term investment results.

TABLE 1. Value of \$10,000 invested for the 30 years to 31 December 2011

Asset Class	Value of Investment	Difference to Australian Equities	
		(\$)	(%)
Australian Equities	234,348	0	0%
International Equities (Unhedged)	154,282	-80,066	-34%
Property	139,870	-94,479	-40%
Australian Fixed Interest	177,540	-56,809	-24%
Cash	86,031	-148,317	-63%

Source: Please see appendix 1.

CHART 5 shows the results of **TABLE 1** in chart form to illustrate the volatility in returns. Whilst Australian shares performed well over the period, it was not a smooth ride, particularly in the market turmoil of November 2007 to March 2009.



Source: Please see appendix 1.

Other noteworthy features of **CHART 5** include:

- Over the 30 year period to 31 December 2011, all growth assets outperformed defensive assets (fixed interest securities and cash);
- The outperformance of the growth assets compared to the defensive assets was hampered by the significant losses experienced by the growth assets during the GFC;
- In early 2009, the value of property slipped below that of fixed interest. However, a major recovery in the second half of 2009 allowed property to outperform fixed interest by the end of the investment period;
- The strengthening Australian dollar over the last decade or so has had a big effect on unhedged international shares. This is because these international investments are held in other currencies (e.g. US dollars) and their value will fall when measured in Australian dollar terms if the Australian dollar strengthens against the currencies in which the shares are held. This led to significant losses in international shares during 2001 to 2009, as the currency generally strengthened during that period. Investors should also note that unhedged international assets will rise in value as and when the Australian dollar weakens; and
- As can be seen in **CHART 5**, during times of poor economic conditions defensive assets generally outperform growth assets such as shares. As such, diversification across asset classes should be considered during portfolio construction. An allocation to defensive assets (such as defensive portfolios that include longer dated government bonds) may act like insurance during periods of economic stress, increasing in value when growth assets are struggling.

Although **CHART 5** shows that the returns of growth assets are much more volatile than those of defensive assets, it is important to consider the risks over periods greater than one year. Decisions based on the short-term performance of assets are likely to be too short-sighted and may be detrimental to achieving the investment objective.

CHART 5 does not show the considerable reduction in the volatility of rolling average returns for periods greater than one year. Let's start by looking at annual returns measured each month.

CHART 6 shows the volatility in rolling one year returns.

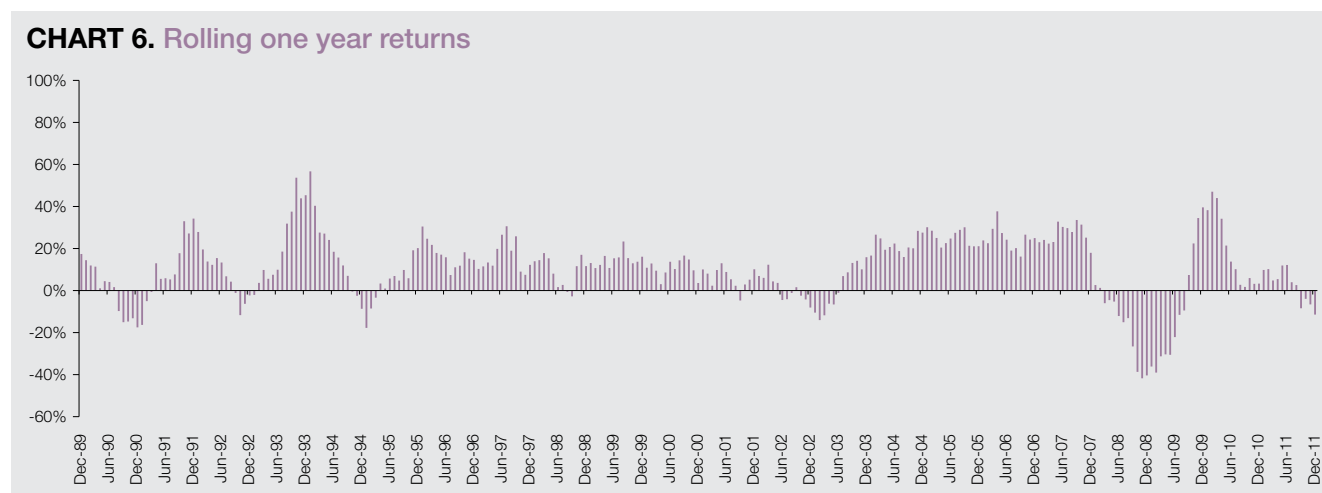
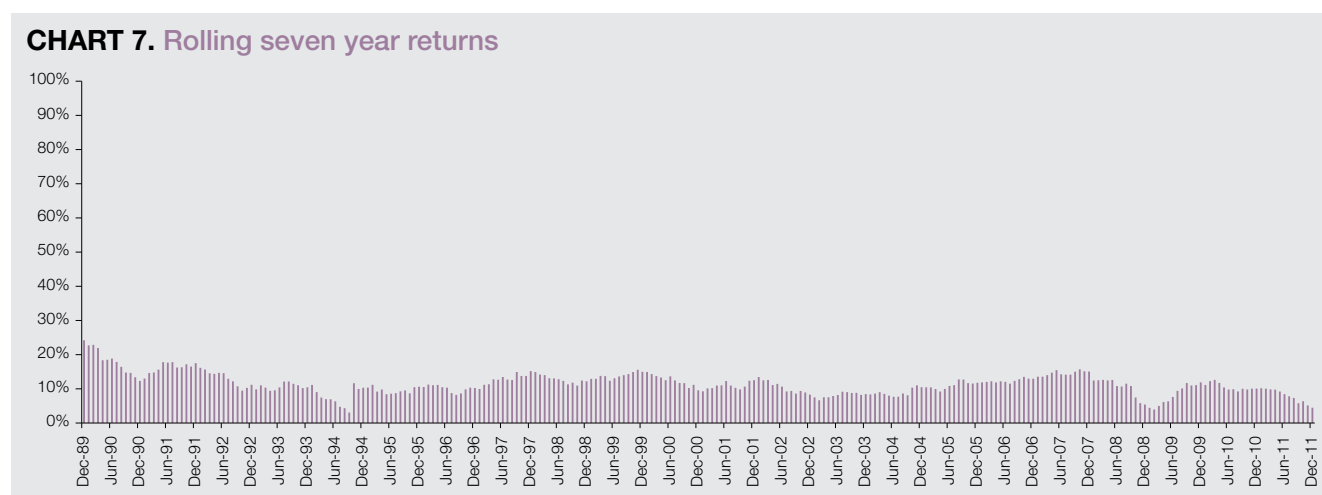


CHART 7 looks at the same time period, but shows annualised seven year returns measured each month. As can be seen from **CHART 7**, over a longer-term investment time frame, the volatility reduces significantly. Over all seven year periods the seven year return was always positive.



Source: Perennial Investment Partners, IRESSAs at 31 December 2011.

These results show that despite the potential for Australian shares to produce considerable one year losses, and considerable one year gains, the range of returns are much less remarkable when considering seven year rolling averages.

One of the most standout statistics is that the average annual return over a seven year rolling period was 12.42% p.a. This shows that the short-term fluctuations in growth assets are markedly less over longer investment periods. Therefore, growth assets have significantly reduced volatility over longer investment periods. As you can see from **CHART 7**, over the period, there was only a small number of seven year rolling average returns that fell below 12%. However, it must be stressed that the figures in this analysis are based on historical performances of asset classes. There is no guarantee that the relative performances of the asset classes will continue into the future.

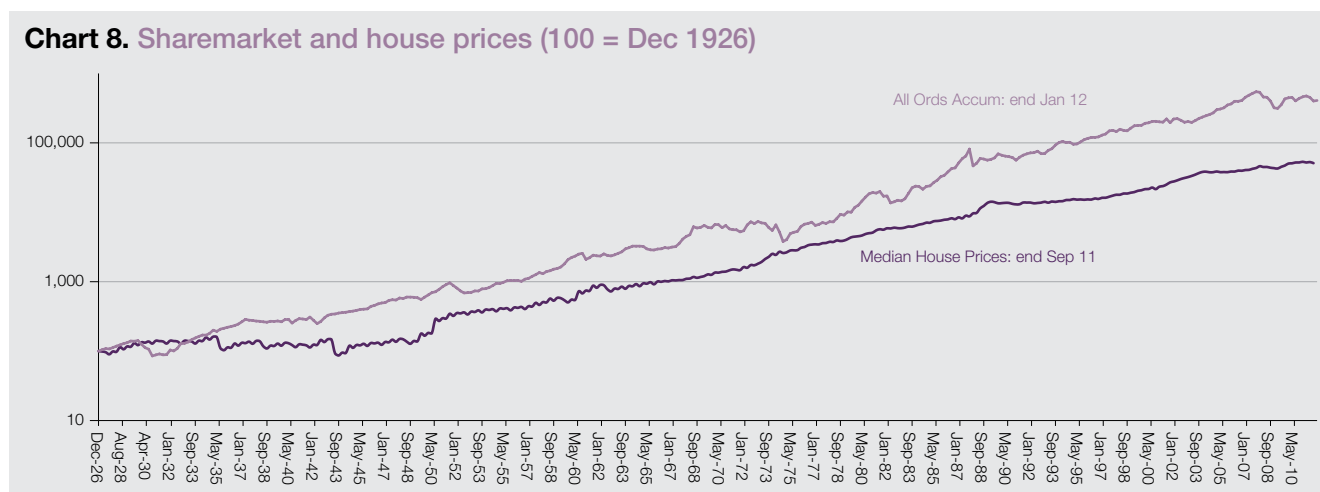
The long-term: Australian residential property

Residential property investment is a very popular investment in Australia, either as a home to live in or a tax-effective investment. Residential property is very hard to compare to shares.

TABLE 2	Shares	Residential Property
Size of investment	Can buy with small dollar amounts and typically buy a portfolio of a number of shares to reduce risk. Even with relatively small dollar investments, risk can be diversified by using a managed fund.	Can typically only buy in large dollar amounts, risk cannot be easily diversified.
Cost of ownership	There will usually be a brokerage fee if shares are purchased through a broker and an annual management fee if the shares are purchased via a managed fund.	Residential property typically involves high transaction costs (real estate agents fees, stamp duty, loan fees), ongoing costs (council fees, maintenance, renovations and insurance).
Investment structure	Most Australians hold shares, either directly or indirectly through their superannuation fund.	Most Australians typically borrow to buy residential property.
Income	Many shares pay dividends.	Rent is typically earned on an investment property or rental costs are saved by the owner if it is a personal residence.

A Chart to view with caution!

Despite all these differences, **CHART 8** shows that longer-term median house prices and Australian shares can both provide good long-term returns. Whilst rental income has not been added to the house price series (rents vary considerably), it is also important to note that the chart does not look at the large differences in long-term costs of ownership that are highlighted in **TABLE 2**. The important point here is that it is very difficult to compare investments in a portfolio of shares to an investment in residential property, other than to say both are viable long-term investments.



As at 31 December 2011.

Source: ASX, Perennial, House prices (Sydney house price 1926 to 1970 (Abelson 2004), REIA Sydney & Melbourne 1970 to September 1986, September 1986 onwards REIA national median).

The long-term: Conclusions

The purpose of this paper is to give an insight into long-term investing and to get investors thinking about the importance of their investment goals. Read in conjunction with *The Wisdom of Great Investors*, it is clear that deciding upon an appropriate investment strategy and sticking to it, even when the going gets tough, are important factors in successful investing and achieving your investment goals.

Looking at the core asset classes individually, the charts included in this paper show how volatile growth assets can be in the short-term, and how risk can be reduced and the volatility of returns lessened when a longer-term investment timeframe is adopted. The charts also highlight the benefits of a well diversified investment portfolio of defensive and growth investments.

The GFC certainly challenged all investment theories and approaches, with long-term investing one of those approaches being brought into question. **CHART 7** tells a powerful story that, even with the massive sharemarket shake up of recent times, to 31 December 2011, average rolling seven year returns still produced a very acceptable 12.42% p.a. return over the period shown.

APPENDIX 1. Calculations by Rice Warner Actuaries based on the following indices:

Asset class	Index
Australian Equities	S&P/ASX 300 Merged Accumulation Index
International Equities	MSCI World ex Australia in \$A (Unhedged)
Listed Australian Property	S&P/ASX 200 Property Merged Accumulation Index
Australian Fixed Interest	UBS Composite Bond Index CBBI, All Maturities, All Series
Cash	UBS Bank Bill



Phone
+612 8274 2700

Email
invest@perennial.net.au

Visit
www.perennial.net.au

Issued by: The Investment Manager, Perennial Investment Partners Limited ABN 59 087 901 620, AFSL 238763. Sub Managers: Perennial Value Management Limited ABN 22 090 879 904, AFSL 247293. Perennial Fixed Interest Partners Pty Ltd ABN 35 099 336 357, Perennial International Equities Management Pty Ltd ABN 39 099 336 375, Perennial Growth Management Pty Ltd ABN 41 099 336 384 and Perennial Real Estate Investments Pty Limited ABN 35 117 913 685 are Authorised Representatives and Subsidiaries of Perennial Investment Partners Limited. Responsible Entity: IOOF Investment Management Limited ABN 53 006 695 021, AFSL 230524. While every effort has been made to ensure the information in this brochure is accurate, its accuracy, reliability or completeness is not guaranteed. Perennial expressly advises that it shall not be liable in any way whatsoever for any loss or damage which may be suffered by any person relying upon such information or any opinion, analysis, recommendations or conclusions contained in this document or otherwise arising in connection with the contents of or any omission from this document. Past performance is not a reliable indicator of future performance. The contents of this document were prepared for general use only. Accordingly, reliance should not be placed on this document as the basis for making an investment, financial or other decisions. This information does not take into account your investment objectives, particular needs or financial situation. PIP2342/3-degrees