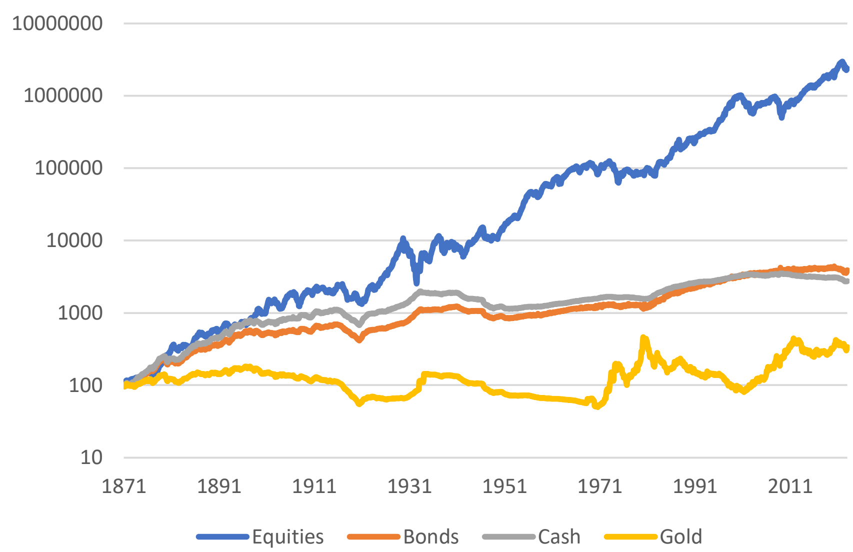
Equities for the long-term

Westminster Assets Management's Investment Strategist Peter Lucas looks at the rationale for equities in long-term investment by considering the historic empirical evidence.

Although equities have been the best performing asset in the long run, they have also been one of the riskiest. After several big drawdowns in the past twenty years – the bursting of the technology bubble (2000-03), the global financial crisis (2007-09) and COVID lockdowns (2020) – some investors have understandably concluded that equities are too hot to handle, preferring the relative 'safety' of bonds. In this article we make the case for them to think again. We examine the long-term performance credentials of equities and we take a more detailed look at the risks associated with equity investment.

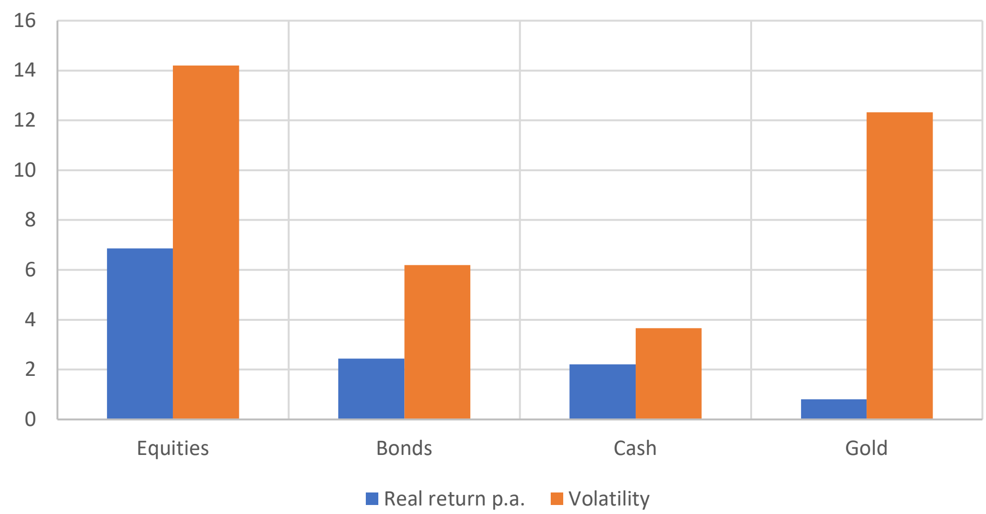
US investment returns, CPI adjusted (1871-2023)



Source: Robert Shiller, Bloomberg, Westminster

The above chart clearly shows the superior returns delivered by US equities over the long-term. The lines reflect the total return of each asset, with income reinvested and after allowing for changes in consumer prices. This latter point is important because beating inflation is or should be the primary aim of any investment portfolio to ensure that the purchasing power of the investor's savings is maintained or ideally enhanced. Note that the vertical axis is a log scale, which means that a constant growth rate appears as a straight line.

US risk and return statistics (1871-2023)



Source: Robert Shiller, Bloomberg, Westminster

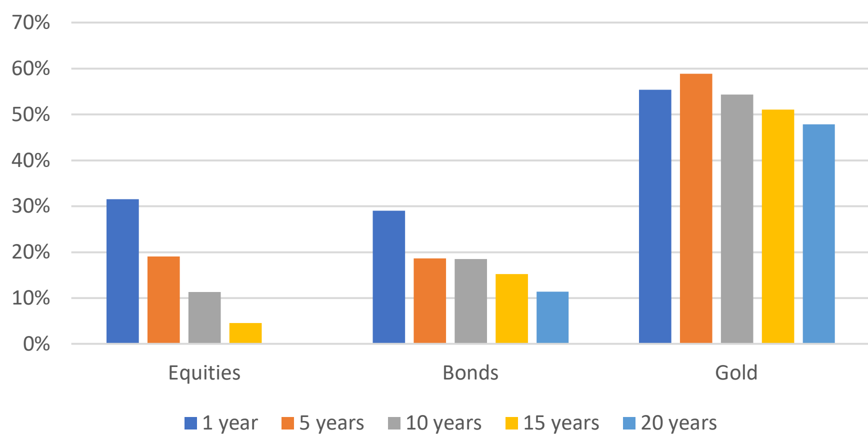
Bonds have edged out cash in the long run because, in keeping with liquidity preference theory, long-term interest rates are typically higher than short-term interest rates, or at least they have been since the 1930's. Fixed income securities give the comfort of regular cashflows but offer no protection against accelerating inflation given their fixed coupons (interest rate payments).

As a non-yielding but scarce asset, gold has done roughly what one would perhaps expect of it, generating a real return close to zero (with equity-type levels of risk). Although not an obvious go-to investment, gold is worthy of consideration given the inflation protection that it bestows and the fact that it carries no counterparty risk. It can also be thought of as the ultimate hedge against bad policy making. In other words, it is a form of portfolio insurance that should not be owned in big quantities other than on a tactical basis.

Equities have the edge over the other assets because they offer some degree of inflation protection (companies own real assets and can raise prices), pay dividends, and participate in the success (or otherwise) of the economy. In other words, they benefit from the fact that we are constantly finding new ways to produce more from less. Incidentally, an investment in non-precious commodities (not shown in the chart) is the exact opposite – it is a bet against mankind's ingenuity. In the long run the prices of many commodities have declined in real terms, and that is before you make allowance for storage costs and so forth. Nonetheless, like gold, commodities are still worthy of consideration as a tactical hedge against inflation.

We know that equities are risky, regularly experiencing significant drawdowns. However, their solid long-term performance credentials mean that the longer you hold them, the less risky they become. The charts below tell the story quite well.

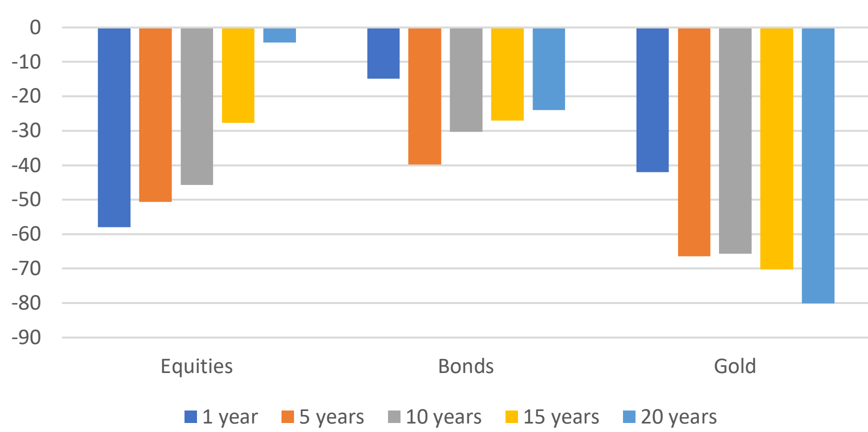
Percent of negative real returns over different holding periods (1871-2023)



Source: Robert Shiller, Bloomberg, Westminster

With all three assets, the risk of generating a negative real return drops the longer that you hold them. However, the drop experienced with equities is much more dramatic than with bonds and gold. Indeed, there has only been one twenty-year period (out of almost 1600) in which US equities have produced a negative 20-year real return.

Worst real return outcome (1871-2023)



Source: Robert Shiller, Bloomberg, Westminster

The above chart looks at the same issue from a different angle. It shows the worst real return experienced over different holding periods. With equities the worst outcome improves considerably as the holding period lengthens, with bonds there is little change, and with gold there is a considerable increase. For investors with a long-term investment horizon, equities are arguably the lowest risk option.

In summary, history demonstrates the benefits of owning equities for the long-term. They produce higher real returns than many if not most of the alternatives, plus their high return credentials mean that the risk of a significant drawdown in real terms diminishes significantly the longer that they are held. Clearly, not everyone can close their eyes for such a long period of time – and equities can inflict significant short-term losses – but this article hopefully demonstrates why equities should form part of all but the most conservative portfolios.

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