



Why super and growth assets like shares really are long-term investments

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Key points

- > While growth assets like shares go through bouts of short-term underperformance versus bonds & cash, they provide superior long-term returns. It makes sense that superannuation has a high exposure to them.
- > The best approach is to simply recognise that super and investing in shares is a long-term investment.

Introduction

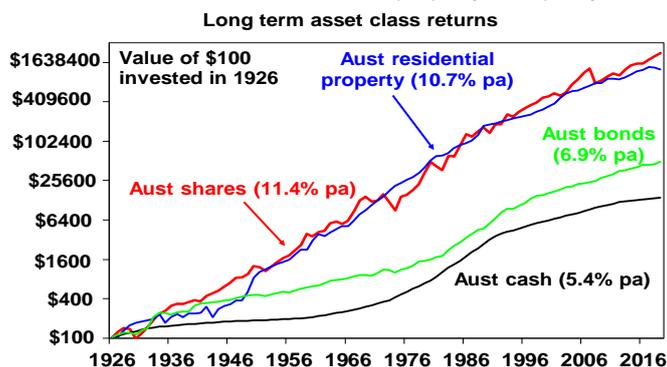
After sharp share market falls when headlines scream about the billions wiped off the market the usual questions are: what caused the fall? what's the outlook? and what does it mean for superannuation? The correct answer to the latter should be something like "nothing really, as super is a long-term investment and share market volatility is normal." But that often sounds like marketing spin. However, the reality is that - except for those who are into trading or are at, or close to, retirement - shares and super really are long-term investments. Here's why.

Super funds and shares

Superannuation is aimed (within reason) at providing maximum (risk-adjusted) funds for use in retirement. So typical Australian super funds have a bias towards shares and other growth assets, particularly for younger members, and some exposure to defensive assets like bonds and cash in order to avoid excessive short-term volatility in returns.

The power of compound interest

These approaches seek to take maximum advantage of the power of compound interest. The next chart shows the value of a \$100 investment in each of Australian cash, bonds, shares and residential property from 1926 assuming any interest, dividends and rents is reinvested along the way. As return series for commercial property and infrastructure only go back a few decades I have used residential property as a proxy.

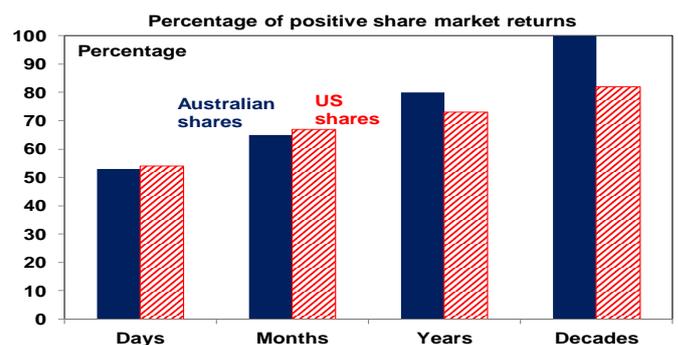


Source: ABS, REIA, Global Financial Data, AMP Capital

Because shares and property provide higher returns over long periods the value of an investment in them compounds to a much higher amount over long periods. So, it makes sense to have a decent exposure to them when saving for retirement. The higher return from shares and growth assets reflects compensation for the greater risk in investing in them – in terms of capital loss, volatility and illiquidity – relative to cash & bonds.

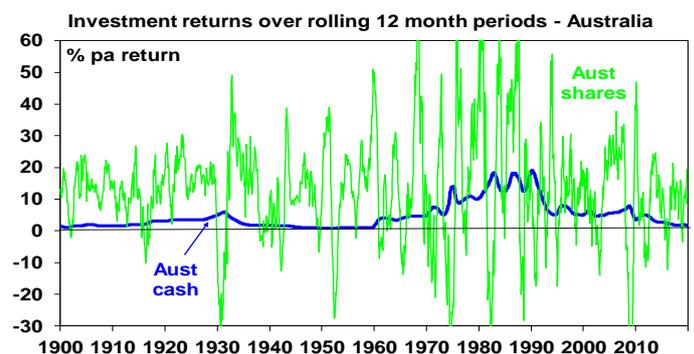
But investors don't have 90 years?

Of course, we don't have ninety odd years to save for retirement. In fact, our natural tendency is to think very short term. And this is where the problem starts. On a day to day basis shares are down almost as much as they are up. See the next chart. So, day to day, it's pretty much a coin toss as to whether you will get good news or bad. So, it's understandable that many are sceptical of them. But if you just look monthly and allow for dividends, the historical experience tells us you will only get bad news around a third of the time. If you go out to once a decade, positive returns have been seen 100% of the time for Australian shares and 82% for US shares.



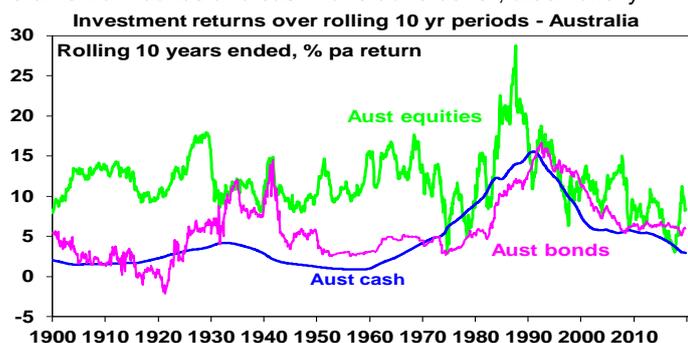
Daily & mthly data from 1995.yrs & decades from 1900. GFD, AMP Capital

This can also be demonstrated in the following charts. On a rolling 12 month ended basis the returns from shares bounce around all over the place relative to cash and bonds.



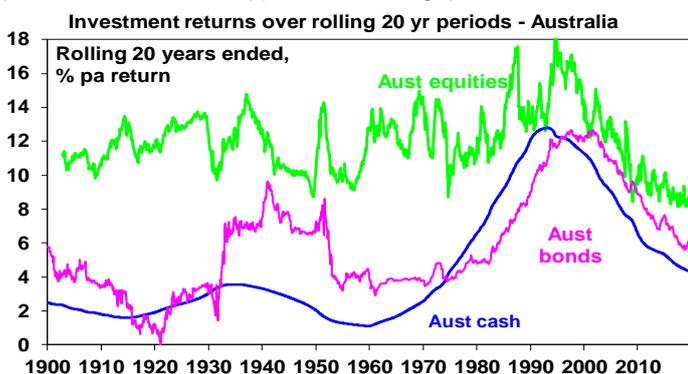
Source: Global Financial Data, AMP Capital

However, over rolling ten-year periods, shares have invariably done better, although there have been some periods where returns from bonds and cash have done better, albeit briefly.



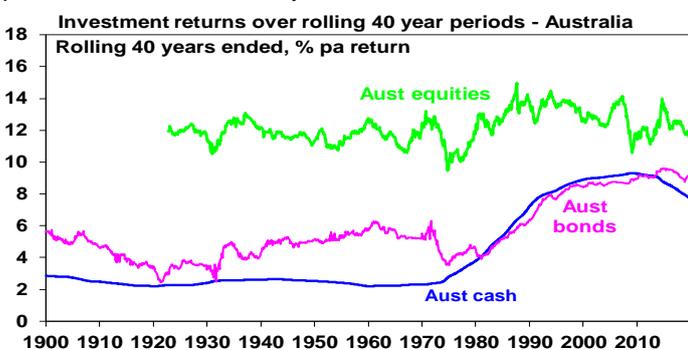
Source: Global Financial Data, AMP Capital

Pushing the horizon out to rolling 20-year returns has almost always seen shares do even better, although a surge in cash and bond returns from the 1970s/1980s (after high inflation pushed interest rates up) has seen the gap narrow.



Source: Global Financial Data, AMP Capital

Over rolling 40-year periods – the working years of a typical person – shares have always done better.



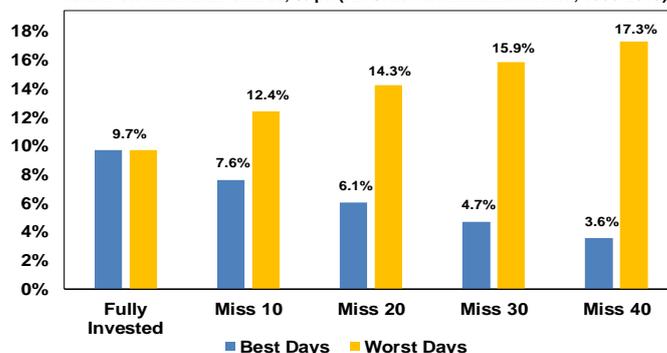
Source: Global Financial Data, AMP Capital

This is all consistent with the basic proposition that higher short-term volatility from shares (often reflecting exposure to periods of falling profits and a risk that companies go bust) is rewarded over the long term with higher returns.

But why not try and time short-term market moves?

The temptation to do this is immense. With the benefit of hindsight many swings in markets like the tech boom and bust and the GFC look inevitable and hence forecastable and so it's natural to think "why not give it a go?" by switching between say cash and shares within your super to anticipate market moves. Fair enough if you have a process and put the effort in. But without a tried and tested market timing process, trying to time the market is difficult. A good way to demonstrate this is with a comparison of returns if an investor is fully invested in shares versus missing out on the best (or worst) days. The next chart shows that if you were fully invested in Australian shares from January 1995, you would have returned 9.7% pa (with dividends but not allowing for franking credits, tax and fees).

Missing the best days and the worst days
Return on Australian shares, % pa (All Ords Accumulation Index, 1995-2019)

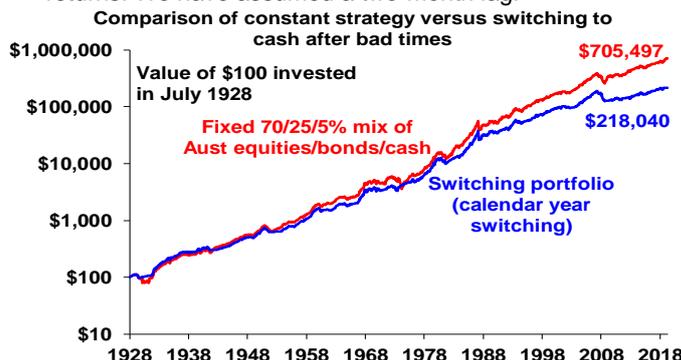


Source: Bloomberg, AMP Capital

If by trying to time the market you avoided the 10 worst days (yellow bars), you would have boosted your return to 12.4% pa. And if you avoided the 40 worst days, it would have been boosted to 17.3% pa! But this is very hard, and many investors only get out after the bad returns have occurred, just in time to miss some of the best days. For example, if by trying to time the market you miss the 10 best days (blue bars), the return falls to 7.6% pa. If you miss the 40 best days, it drops to just 3.6% pa.

The following chart shows the difficulties of short-term timing in another way. It shows the cumulative return of two portfolios.

- A fixed balanced mix of 70 per cent Australian equities, 25 per cent bonds and five per cent cash;
- A "switching portfolio" which starts off with the above but moves 100 per cent into cash after any negative calendar year in the balanced portfolio and doesn't move back until after the balanced portfolio has a calendar year of positive returns. We have assumed a two-month lag.



Source: Global Financial Data, AMP Capital

Over the long run the switching portfolio produces an average return of 8.8% pa versus 10.2% pa for the balanced mix. From a \$100 investment in 1928 the switching portfolio would have grown to \$218,040 compared to \$705,497 for the constant mix.

Key messages

First, while shares and other growth assets go through periods of short-term underperformance relative to bonds and cash they provide superior returns over the long term. As such it makes sense that superannuation has a high exposure to them.

Second, switching to cash after a bad patch is not the best strategy for maximising wealth over time.

Third, the less you look at your investments the less you will be disappointed. This reduces the chance of selling at the wrong time or adopting an overly cautious stance.

The best approach is to simply recognise that super and investing in shares is a long-term investment. The exceptions to this are if you are really into putting in the effort to getting short-term trading right and/or you are close to, or in, retirement.

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