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We've been here before

By Doug Turek

PORTFOLIO POINT: It may take years for asset prices to recover but don't despair because returns from here are much better than they were at the peak.

Now that the Australian stockmarket has been moving sideways for almost two years and concerns are growing that residential property prices will enter a similar holding pattern, you won't be alone in wondering how much longer you need to wait for markets to regain their momentum.

Although it's not unusual for investors to hope for a swift recovery, it might pay to put these events into a historical context.

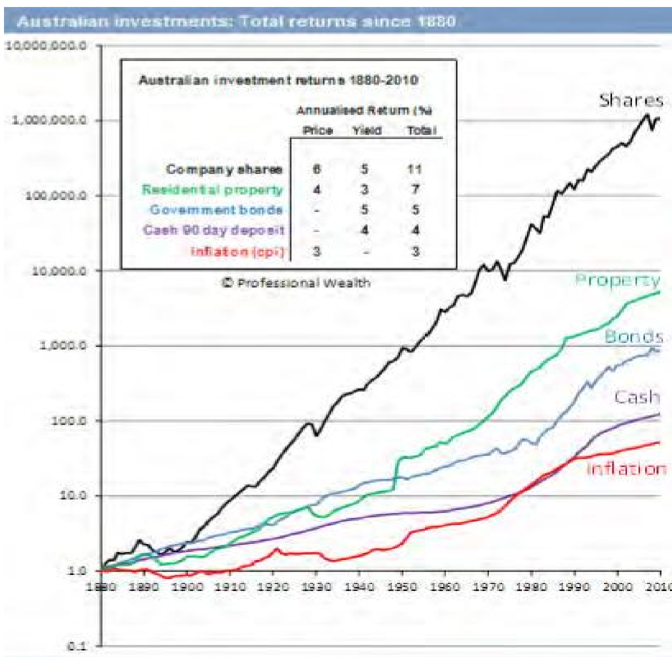
As I'm about to show you, after examining the past 130 years of investment returns across Australian asset classes, I have identified a number of periods in which the stock and property markets have undergone considerable periods of little or no capital growth.

Although I'm not making a forecast either way, it's crucial that investors view current events in the market in the proper historical context. Perhaps even more importantly, if only for our peace of mind, there is good news to be had as well.

130 years of happy returns

It will come as no surprise that my analysis of investment returns – including both price gain and reinvested income – across a series of assets classes versus inflation since 1880 shows that investing in Australian companies has been the fastest way to build your wealth over the long term.

Australian investments: Total returns since 1880



Australian shares delivered an 11% annualised total return, or about 1% less than if you measured this to 2000 or started after the 1890 Australian depression. This 11% is made up of 6% price (corporate earnings) growth and an average dividend yield of 5% (not counting the benefits of franking credits introduced in 1987).

Investing in Australian capital city residential property returned 7% annually since 1880. That includes average price appreciation of a little over 4% (after a small 0.6% adjustment for changes in property quality, as per work done by Nigel Stapledon, whose data we have used) and average net rental return of just under 3%.

Generally we expect property prices to rise with wage inflation, but since about 1950 prices have been rising at a much faster 7%, and in part because of this yields have fallen, taking the total return to 9%.

Lending money is considered a less risky activity so the returns are smaller. The returns from Australian 10-year government bonds and cash averaged about 5% and 4% respectively.

As for gold, its price of $US20 an ounce changed little until 1930 and did not break $US40 until 1971. Having increased about 75-fold in price since 1890 to the current $US1500, it would be positioned close to the compound returns for cash and inflation.

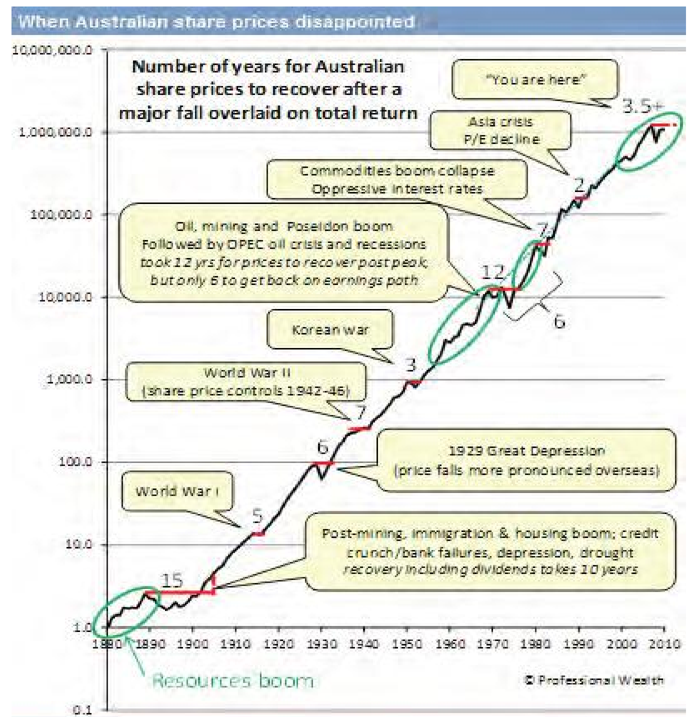
Of course few invest with an investment horizon of 130 years, so let's look at returns from each asset class over shorter periods. What I'm about to do is focus ONLY on when these investments disappoint and consider how long it took prices to recover.

We will be looking at their returns through dark (not rose-coloured) glasses!

Grizzly times for share investing

If you are focused on sharemarket prices only and consider that the yield is what you need to equal staying in cash, then there have been half a dozen

When Australian share prices disappointed



times in the past 130 years when it has taken more than the current three-and-a-half years for Australian share prices to recover back to their previous peak after a substantial fall.

The longest period was the 15 years following the Australian mining,

immigration, credit and speculative housing boom of 1890. If you include dividends, investors would have broken even after 10 years although if you were looking at prices only it took another five years to reach its peak.

More recently, it took 12 long years for share prices to recover their previous 1969 Poseidon boom era peak and to get through shocks from the Vietnam War and OPEC-induced inflation.

While Australian history suggests you probably need to wait until 2015, or at worst 2020, for the All Ordinaries price to return to 6700, don't despair too much.

If you can earn a franking assisted yield of 5% and the market recovers 2000 points (from 4700) in the next four years then your forward annual return will be 15%. If it takes another eight years it will be 10%.

Of course, markets can fall back further while you are awaiting a recovery, as they did in 1973 after having travelled sideways for five years. Many forget that in the Great Depression the US market fell harder in 1931 than it did during the original crash in 1929.

A big factor that drives share prices down is a reduction in the price/earnings (P/E) multiple – driven lower by both investor pessimism and also made less attractive by higher cash rates and bond yields.

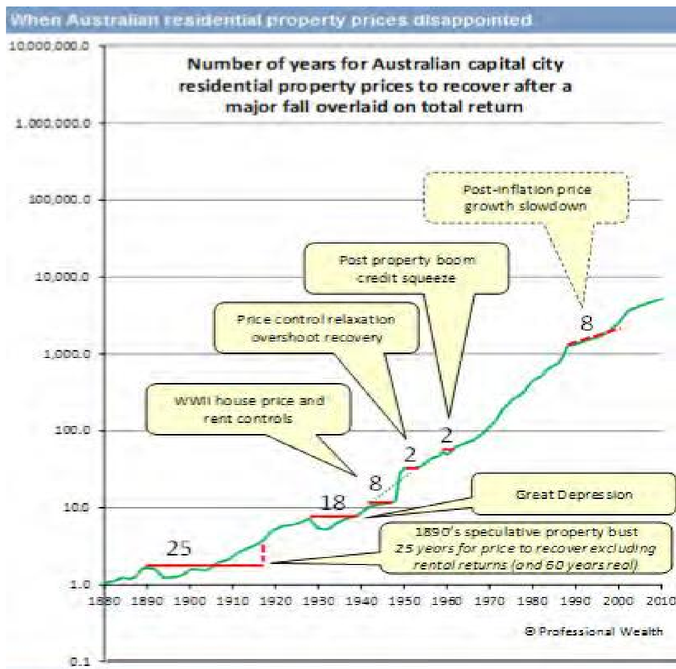
While there is some debate about what is the fair way to measure P/E at this time, the market is not unfairly valued and is some way away from being deeply discounted. A collapse in P/E would thus see us retest the lows observed in March 2009 –a very scary but attractive entry point for additional investment.

Unfortunately, history shows us that most booms end with a difficult readjustment (or "bust").This includes mining booms.

Australia's first housing bubble

It is unlikely that many Eureka Report readers bought property at the peak of the market in 1890, but if you did you would have had to wait 25 years for the price to recover (excluding any constant quality adjustments, which would have stretched this out even longer). What's worse is that if you wanted back your money adjusted for inflation, you had to stay invested for 60 years – until 1950.

Property prices also stayed flat for about 18 years during the Great Depression and then flat-lined again under government price and rent controls for another eight years in the 1940s. As evidence that markets work, when these controls were relaxed property prices and rental yields recovered dramatically, continuing on the market's price trajectory as shown by the dotted line.



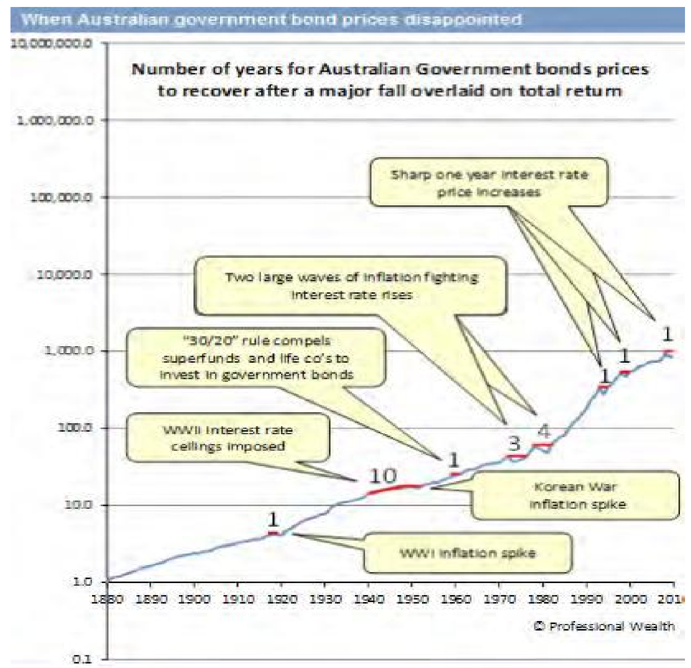
Since the 1950s, when perhaps the endless supply of cheap land ran out, property prices have in the whole climbed quite reliably – more so than for shares. Only twice have house prices in aggregate fallen since and each time it only took two years to bounce back. Notably after the big inflationary price gains in the 1970s and 1980s, property prices grew at an anaemic 2% annually for the eight years from 1989 to 1997.

Is that a harbinger of what to expect from today's very low rental yields and indicative over-valuation? Maybe. However, if severe and prolonged unemployment emerges, then it may pay to remember that substantial property price collapses take much longer than shares to recover from.

Bonds –shaken not stirred

Most DIY investors don't get bonds – literally – because of lack of supply and due to large minimum investment required for most of them (click here). This is a shame because bonds have generally outpaced cash, falling in value for short sharp periods only when interest rates rise surprisingly. When interest rates rise expectedly this is built in as a higher yield.

As shown below, nominal bonds weren't a great investment at the start of the 1970s inflation period, which ran painfully for 20 years. Then it took three or four years for the prices of bonds locked into lower interest rates to recover after falling. To avoid this, consider including inflation linked bonds in your defensive portfolio where your investment returns should more closely track CPI.



The other times bonds disappoint are when governments interfere, as they did during World War II when they capped interest rates; and also in 1961, when they compelled super funds and life insurance companies to invest in government bonds.

Political risk is a real issue in bond investing, which is why I wince every time the government and other commentators pine that your super funds should invest in things such as infrastructure bonds. Many US pension funds

are required to invest in US government debt, which is the financial equivalent of thievery or patriotism, depending on your point of view.

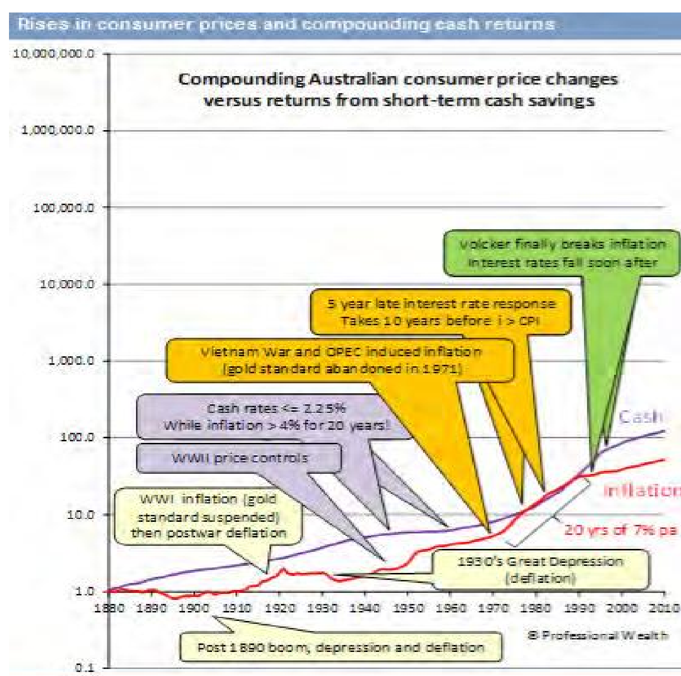
When cash provides illusory security

Cash disappoints when interest rates fall and reduce the income many try to live off, as we saw during the GFC. An even greater disappointment is when interest rates don't rise fast enough to keep up with rising prices. At the moment, this isn't a problem, but it has been in the past – and it is if you live in the US or the UK.

During the 1940s and 1950s government policy kept interest rates to between 0.5% and 2.25% to support the war and later help pay off that debt, despite inflation averaging 4% annually and peaking in 1951 at 18%.

In a second phase of disappointment, shown below, interest rates did not start materially rising until 1975 or five years, after inflation broke out. Worse, it wasn't until 1981 – more than 10 years later – that interest rates were higher than the rate of consumer price inflation.

With many Australians so heavily indebted, one might wonder if the Reserve Bank only has limited inflation-fighting interest rate rises before it might have to surrender that objective to avoid causing financial instability. It is also supremely ironic that defensive investors simply swap equity risk for interest rate setting risk when retreating to cash in times like these.



As for a genuine banking crisis, we have to look back to the 1890s to find a substantial event that qualifies. At the time banks in Sydney and Melbourne locked their doors, unable to give back depositors' money, which was invested in many speculative property ventures after the mining, immigration and credit booms. Investors should take note that the federal government's $1 million guarantee is set to end soon, with a hint that it will be maintained for deposits of about $100,000.

A global perspective

Carmen Reinhart and Kenneth Rogoff recently published a sobering inventory of global financial crises over the past eight centuries, entitled *This time is different* – the title a caution to those who believe booms will continue. Their catalogue includes banking crises, sovereign defaults, exchange rate collapses and bouts of high inflation, which often occur in clusters.

Over more recent history, they found that following a major financial crisis share prices fell on average 56%, hitting their bottom after falling for an average 3.4 years. While real house prices fell a lesser 35% on average, it took six years for prices to stop falling (in Japan it took 17 years). They point out the global nature of the current crisis makes it less easy than it was in the past for individual countries to export themselves out of their problems.

To an overseas reader/investor, Australia could easily look like a country at the end of a boom period with a worrying high exposure to a traditional boom/bust resource sector and a highly leveraged bank-supported property sector.

"If there is one common theme to the vast range of crises we consider in this book, it is that excessive debt accumulation – whether it be by the government, banks, corporations or consumers – often poses greater risk than it seems during a boom. Infusions of cash can make a government look like it is providing greater growth to its economy than it really is. Private sector borrowing binges can inflate housing and stock prices far beyond their long-run sustainable levels, and make banks seem more stable and profitable than they really are ... Debt-fuelled booms all too often provide false affirmation of a government's policies, a financial institution's ability to make outsized profits, or a country's standard of living. Most of these booms end badly."

So ...

If you torture returns data long enough, such as by manipulating start and end dates, not using the right scale or neglecting inflation or income, you can get it to confess to anything. Instead, it is important to look at returns with a very long lens, as we have here. While the steady rise in real returns for all of the major asset classes is encouraging, it doesn't take away periods of disappointment.

- Share prices can easily go sideways for a decade, but at least since 1900 have always got back on to their long-term return trajectory and rewarded investors who stood bravely by them with forward capital gains.
- Residential property has been pretty reliable since the 1950s in Australia, however prices can languish even longer than shares in bad times. With yields at an all-time low, there is less room for them to keep going up, so perhaps a period of slow growth like in the 1990s is ahead of us.
- Bonds and cash are defensive only when interest rates better inflation and your currency stays strong, which sometimes through intervention isn't the case. Fortunately we're fine now, but not offshore, or maybe not for long.

I share many people's concern about the fragility of our near-term economic future, but also an appreciation that diversification is critical to manage your way through evolving circumstances. It will no doubt be interesting to read what future history is written from here. ◆

Doug Turek is the principal adviser of independently owned family wealth advisory firm Professional Wealth and maintains an ongoing interest in economic history.

Editorial comments

Doug's no-nonsense facts about the long-term returns from various asset classes, combined with a careful assessment of downside risks, provides investors with the building blocks they need to build a long-term investment strategy at a time when fear is everywhere.

– Scott Francis