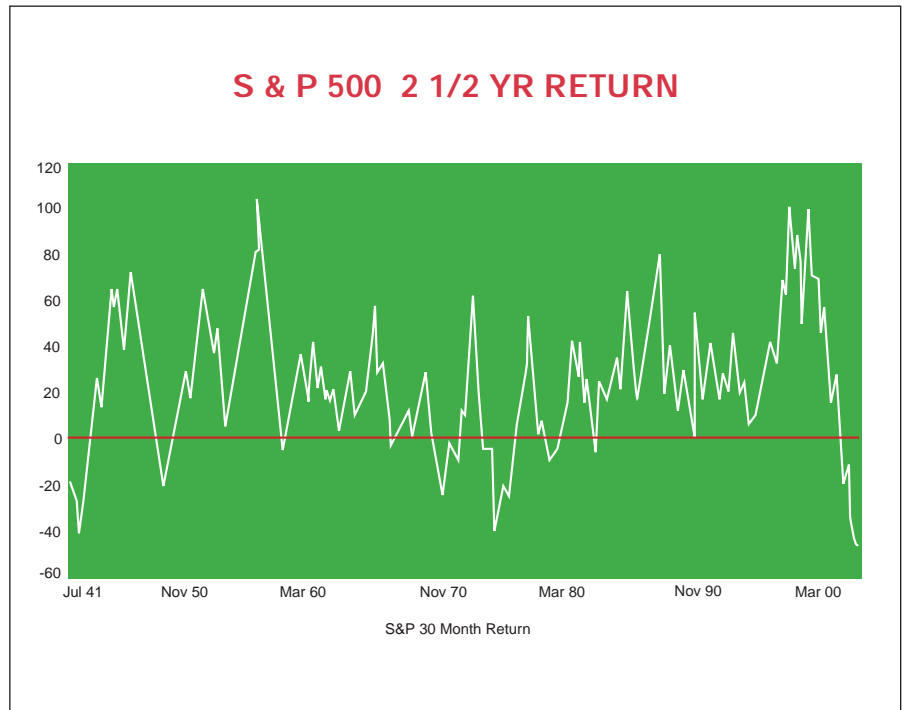


# Is the Bear finally retreating?

BY PRAMIT GHOSE

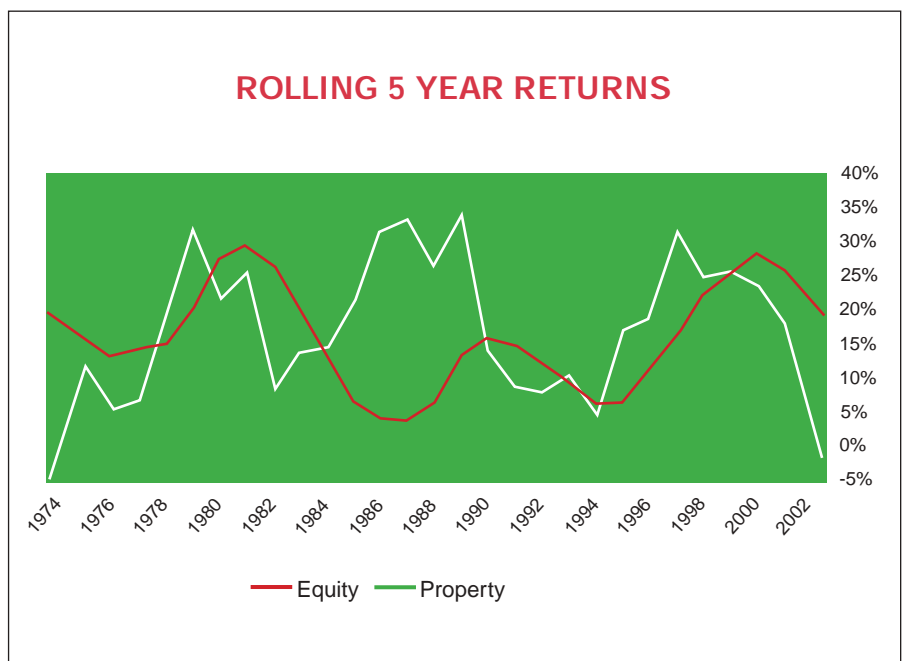
The current bear market in equities has been one of the worst ever in terms of both the amount of the falls and duration. According to Elroy, Dimson and Staunton in their book *ABN Global Investment Returns Yearbook 2002*, the probability of three years in a row of negative real returns from equities is 6%, while the probability of four years in a row of negative real returns is 1%. One has to go back to the depression era of the 1930's to find the last time the US stockmarket experienced three years in a row of negative returns. It looks like the bubble in the stockmarkets of the late 1990's has been burst.

This graph (right) illustrates the 30 month return on the US stockmarket since 1940 and shows that the fall in markets we have just experienced is worse than the falls experienced in the grizzly bear markets of 1941 and 1974.



Looking at the recent low in the US stockmarket on 9th October 2002 (775 on the S&P 500 index), if one assumed it would take 10 years from that date until the March 2000 highs were reached again (i.e. a period of 12.5 years until the peak was reached again), then the return over this ten year period would be 9.25% per annum, allowing for a 2% dividend yield.

If we look at the competing asset of property, it is clear that the probability over the next five years is that equities will outperform property. The chart below examines the rolling 5 year returns on Irish equities and Irish commercial property – what it shows is that both asset classes have their bouts of outperformance, and that if history is anything to go by, then it's the equity market's turn.



There are a number of arguments circulating that despite the falls in equity markets over the past 2.5 years they remain expensive and have more to fall.

Price earnings ratios for the UK, European and US markets are in the 15 to 18 times range, which compares with around 10 times at the 1982 lows and around 8 times at the 1974 lows. However, what is important is the price of the competing asset classes, in particular bond yields. Back in 1982 US bond yields were around 14%, while in 1974 they were around 8%. Currently US 10 year bonds yield 4% while Euro 10 year bonds yield 4.5%.

The famous 'Greenspan' model suggests the US market is some 20% undervalued (i.e. Dr Greenspan thinks equity markets are fairly valued when the earnings yield equals the 10 year bond yield).

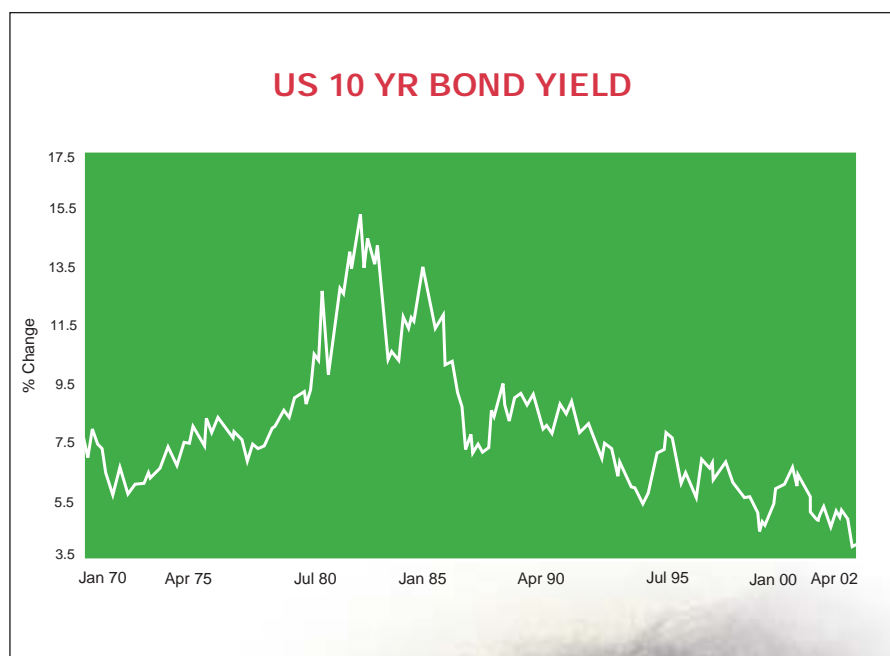
### THE BOND MARKET

On the other hand, fears of deflation and a flight to safety by investors have pushed yields on government bonds across the world to multi-year lows – the graph below illustrates the move in US 10 year government bonds. This is a major reason why the cost of providing pensions has shot up in recent years at a time when roughly 65% - 70% of the average pension scheme's assets have fallen dramatically. It is an extremely rare event in western financial markets for this to happen.

### FUTURE EQUITY INVESTMENT RETURNS

The previous section explains why we believe the overvaluation of equity markets that occurred in the late 1990s' has been corrected, and that it is reasonable to assume the worst of the bear market is behind us. We believe the markets are currently in a bottoming out process. Although it is impossible to tell how long this bottoming out process will last, we believe it is reasonable to assume that stockmarkets should return to a more normal environment over the next five to ten years.

In our opinion, equities will, over the long-term, outperform bonds and provide a better hedge against an unexpected period of deflation which is not currently anticipated by the bond markets, i.e. the rate of inflation unexpectedly rises. It is fair, however, to assume the excess returns over inflation achieved by equities in the 1980s' and 1990s' are unlikely to be achieved over the next ten years, and that a more modest outperformance of around 4% to 5% p.a. is likely. I set out below the reasons for this conclusion.



Looking first of all at the Irish stockmarket, Shane Whelan has calculated stockmarket and inflation indices back to 1899. Over the 103 year period to November 2002 (i.e. taking in the worst effects of the current bear market), the annualised real rate of return on equities was 4.5%. Breaking this down by 10 year periods gives the following table :

10 years to end	Equity Return	Inflation Rate	Real Return
2001	18.3%	2.7%	15.1%
1991	19.5%	5.4%	13.4%
1981	14.9%	15.3%	-0.4%
1971	12.2%	5.6%	6.2%
1961	8.6%	3.0%	5.4%
1951	8.8%	4.3%	4.4%
1941	3.6%	3.6%	0.0%
1931	7.5%	-3.1%	10.9%
1921	1.9%	8.8%	-6.4%
1911	2.2%	0.7%	1.4%

The average real return of these 10 year periods is 5.0% p.a. It is interesting to note that the two periods which show negative real returns for equities were periods with a relatively high rate of inflation (15.3% and 8.8%) – it is unlikely that inflation at these rates will occur again over the next ten years.

Using the ABN Global Investment Returns Yearbook 2002, we can look at real returns in the major international equity markets. A similar trend emerges, i.e. generally over 10 year periods there have been significant real returns for equities with the exception of the two high inflation periods of the 1910s' and 1970s'. A summary of the real returns in the major markets for the period 1900 to 2001 is shown below :

Market	Mean Real Return
UK	5.6%
US	6.5%
World	5.5%

**THE EQUITY RISK PREMIUM**

As a check on our forecast of a 4% p.a. real return on equities, it is useful to cite the work done on the equity risk premium in the ABN Yearbook 2002. The equity risk premium is the difference between the return on risky stocks and the return on safe bonds. The equity market premium is central to investment financing and saving decisions. The authors develop a forward-looking arithmetic risk premium of around 3.5% to 4% for the World Index. This figure is lower than frequently quoted historical averages, but give credence to our belief of a 4% real return in the future.

**IMPLICATIONS FOR FUND MANAGEMENT STRUCTURES**

The implications for pension schemes of lower investment returns in the future have

been well debated. What has not been so widely debated is the implications for the way pension funds structure their investment management arrangements. Many fund management companies have struggled to add value over the past five years, while passive or index-tracking managers have made great inroads. According to the end November 2002 survey of Irish pension managed funds, only three of the twelve active fund management companies with a five year track record outperformed the Irish Life Consensus Fund.

As a diehard believer in active fund management, it is not pleasant to read this statistic. As a realist, one has to assume a growing role for passive fund management. However, there are still a reasonable number of fund managers out there with proven and repeatable active fund management skills – the trick is to find and appoint them ! There is room for both types of managers in a pension fund's investment arrangements, and one only has to look at the NTMA's structure for the National Pension Reserve Fund to find an excellent role model, i.e.

- passive and active mandates
- a multi-manager set-up in that 'best of breed' managers have been appointed
- mandates with differing outperformance targets
- rigorous monitoring of mandates

Active managers who are in fact closet index-trackers have much to fear from such structures. They will be squeezed out in the rush to find efficient providers of equity exposure (passive managers) and active stockpickers with proven skill. The Myners Report requires pension fund trustees to become more expert in their knowledge of investment matters, and this is likely to lead to an increase in the use of investment consultants. In my opinion, the implications

for fund management structures are as follows:

- multi-manager structures will become more prevalent
- more funds will adopt a passive approach for part of its investments
- skilled active fund managers, big and small, will gain 'satellite' or high outperformance target mandates
- truly alternative investments, such as the Alder Capital currency fund, will find a place within pension funds' assets
- investment consultants with fund management experience will be in strong demand.



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