

WHERE TO INVEST FOR THE BEST?

After a period of significant volatility in investment markets with especially noticeable falls in value of equity (share) based investments, choosing the right asset class to invest into may appear daunting. World equity values generally recovering may even lead to suspicion that a risk of further fall is imminent.

A standard measure of investment risk is volatility, which indicates the amount an investment fluctuates in value over time. This is often assessed as variance from the average return over time. The least volatile investment class is obviously deposits, which being cash based will only rise over time with the accrual of interest and as such are unlikely in any given period to fluctuate far from the average return. ***However deposits are at risk of inflation erosion.***

Bonds are, effectively, loans to companies or Governments (UK Bonds being known as Gilts) with, typically a fixed rate of interest. This known rate of return will – again typically – be above the prevailing rate of interest at the time the bond is issued. Being a ‘Fixed Interest’ security, bonds tend to have low volatility but not NO volatility. As the prevailing rate of interest changes, so does the value of the fixed rate of return attaching to the bond. A Bond with a 5% fixed rate (known as the ‘Coupon’) will be more attractive when interest rates are less than 5% than when interest rates are more than 5%.

Thus as general interest rates rise, the capital value of a bond investment tends to fall as investors seek better return elsewhere. And vice versa, as interest rates fall, the capital value of a bond is likely to rise as investors realize the relative attraction of bonds’ fixed return.

Similarly, in comparison to equities, when markets are strong and rising (or market sentiment is positive about equities) investors tend to move from bonds to equities and thus bonds are prone to weakness/capital loss. When equity markets are falling or investors are unsure about future prospects, bonds tend to benefit in capital value.

As interest rates and equities do not rise and fall necessarily at the same time, bonds tend to benefit from investors moving away from deposits or away from equities at different times and thus bonds have an inbuilt protection against volatility to a large extent.

However, bonds being ‘defensive’ investments (investors move to bonds as an alternative to their primary choice) they also suffer from investors moving back to their ‘natural preference’, which thus ***tends*** to give bonds a limiting effect on their growth, when compared to other more speculative investments.

Thus bonds have low but not NO volatility and in exchange for the loss of capital security have more potential for growth and tend to at least match interest rates plus inflation return (except in very high inflation periods).

Equities clearly have a high potential for volatility, depending to a large extent on the individual share, investment sector and/or geographical location of the investment.

In exchange for this volatility and lack of any real capital guarantee, equities also have the potential for significant return.

From the above, one thing is clear. There is no single investment disposition that is right for every investor. Individual financial circumstances, objectives, age and Attitude to Risk will all contribute to how a suitable investment portfolio is constructed.

One common factor within all these considerations is investment term, i.e. the likely duration of the prospective investment. Investment volatility means that in the short term it may be that equities easily outperform deposits and bonds, but it also suggests that in a year when equities fall

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in value there is insufficient time for them to recover and outperform the other asset types so Bonds and/or Deposits could easily outperform equities over shorter investment periods.

However, over longer investment periods, if the above characteristics hold true, equities should be a stronger investment and give greater returns with increasing probability as investment duration extends. A review of the three main asset types (Shares, Bonds and Deposits) over the period from 1900 to 2005 (105 years) makes interesting and revealing reading.

Shares outperforming other assets:	number of consecutive years for which assets are held					
	2	3	4	5	10	18
Outperform deposits years	69	72	75	76	89	87
Underperform Deposits years	35	31	27	25	7	1
Total number of years	104	103	102	101	96	88
Probability of Shares Outperformance	66%	70%	74%	75%	93%	99%
Outperform Bonds years	72	78	80	77	80	82
Underperform Bonds years	32	25	22	24	16	6
Total number of years	104	103	102	101	96	88
Probability of Shares Outperformance	69%	76%	78%	76%	83%	93%

Source: Barclays Capital

The figures show that for investment periods of only 2 years, there is a 1 in 3 chance that (in the UK) deposits or bonds will give a better return than shares. Whilst a 1 in 3 chance is a very real opportunity, it also means that over a 2 year period, there is a 2 in 3 chance that shares will perform best. However, if an investor has a real potential need for access to a known sum within the investment period, clearly committing to equity based investment alone is risky.

At the other extreme for investment periods of over ten years, avoiding significant exposure to shares is to risk missing any return beyond interest rates and, possibly inflation. For even longer investment periods (as shown by the 18 consecutive year periods column) the chance that equities will outperform both bonds and deposits extends to **99% and 93%** respectively.

The significant fact is that **NO** single asset class outperforms **ALL** the time, but a spread of investment over the major asset classes should give protection against loss as well as support gains. Even in shorter investment periods, some equity exposure is probably worthwhile, depending on individual tolerance of volatility.

In the later part of the period under review, property (primarily commercial property based) funds came more into vogue. Interestingly, property investment as an asset class does not behave directly in line with equities **or** bonds (i.e. they have low correlation). This asset 'area' looks set to expand with the introduction of REITs (Real Estate Investment Trusts) that have proved successful in markets where they already exist.

A blend of Equities, Bonds, Property (and where appropriate, cash) is therefore likely to be the best starting point for investment portfolio construction.

If the last 105 years is to be believed and continued then a realistic view of individual circumstances and objectives, aimed at developing a portfolio incorporating appropriate asset allocation is the **BEST** answer as to where to invest.