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SPECIAL REPORT

QUOTE

"Change of a long-term or secular nature is usually gradual enough that it is obscured by the noise caused by the short-term….the markets will be adapting to a new set of rules while most market participants will be still playing by the old rules." - Robert Farrell (1930-)

On 1 September 2010, Robert Buckland of Citigroup issued one of the most important investment reports of the year. A summary of the key points follows. The main one is that it pronounced the death of the 52 year old "Cult of the Equity".

> "It has taken 10 years, and two 50% bear markets, to reverse this cult. European and Japanese equities are already trading on dividend yields above government bond yields. US equities are almost there as well. An immediate reincarnation of the **Cult of the Equity** seems unlikely. Global corporates, especially the mega-caps, rushed to exploit cheap financing as the **Cult of the Equity** inflated. They have been slow to redeem equity now that the cult has deflated. Equity oversupply remains a drag on share prices."

And as more and more companies and investors shift their policies, the situation for US pension funds is reverting towards those last seen when the "**Cult of the Equity**" began, in about 1958. UK pension plans are already back to their equity/debt investment levels of the early 1960s.

> "A reduction in equity holdings back to pre-1959 levels (around 20% of total assets) would indicate considerable selling pressure to come. For US private sector pension funds alone, that would imply a further $1,900bn reduction in equity weightings. The evidence suggests that there could still be considerable institutional selling to come."

The report goes on to state:

- The medium- and long-term trends of the market will be set by $2 trillion in equity sales from pension funds alone, as capital flows normalize.
- A seemingly endless push into fixed income by the aging baby boomers. This likely means billions more in ongoing monthly mutual fund redemptions.
- An inevitable change in the (US) regime may eventually encourage investors to sell billions of shares to obtain the current beneficial capital gains taxes.

Bond vs Equities - Then and Now

In July 2010, global equities rebounded despite continued falling government bond yields. This was a change from the strongly positive relationship between equities and bond yields seen since 2000. Many investors worry that this decoupling will be resolved by the bond markets being proven "right". The implications of this are worrying — the last time US treasury yields

Figure 2. S&P Composite Against US Treasury Yield (%, RHS)

were down at these levels, the S&P (now around 1050) was nearer 800.

Citi believes that the debate about the relative attractions of bonds and equities is mere froth on top of a much more profound reassessment of the merits of various asset classes. They ask "Has the cult of the equity been replaced by one of bonds?"

The effect of the cult of the equity is best shown by institutional asset allocations. Figure 3 (figure 1 is omitted) shows the weighting of US private sector pension funds in equities and fixed income. In 1952, they held only 17% of equities compared to 67% in fixed interest. Over the next 50 years, these weightings reversed - at the peak, in 2006, they were 69% in equities and 18% in fixed income. Of course, some of the increase in equities reflects their outperformance over the period.

As shown in Figure 4, the UK situation was similar. In 1962, pension funds held more in bonds than equities. At their peak in the early 1990s, 76% were equities compared to just 12% in bonds. UK pension funds embraced the cult of the equity more enthusiastically than in the US, probably due to that country's more significant inflation problems.

Why the cult?

The cult of the equity began in the late 1950s, early in a welcome period of peace and prosperity following 50 tumultuous years that included two world wars and the Great Depression. At this time, modern portfolio theory established the belief that a well-diversified equity portfolio could achieve

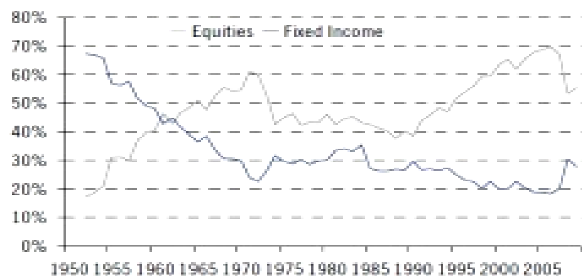


Figure 3. US Private Sect Pension Asset Wts[2] (%)

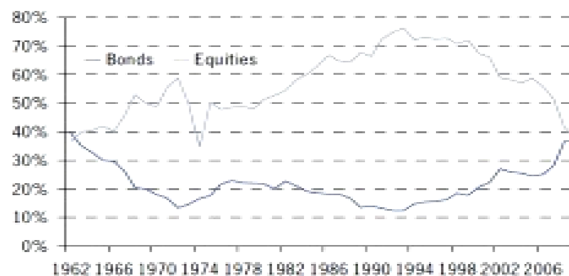
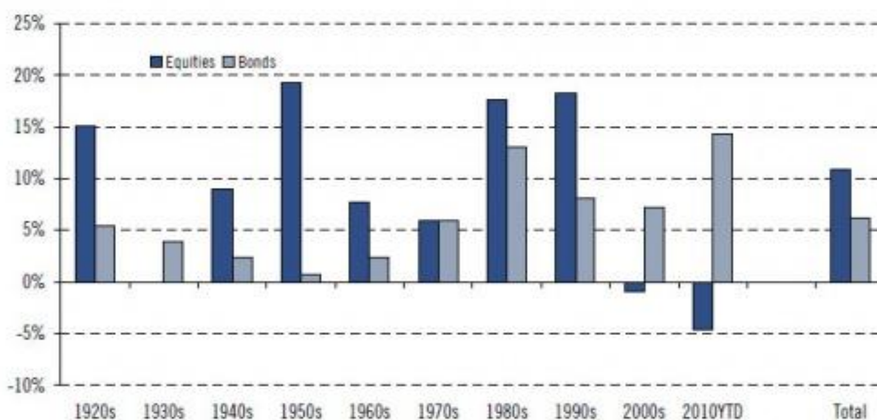


Figure 4. UK Pension Asset Weights (%)

superior returns. The most convincing argument for its widespread adoption is that this was also the beginning of spectacular long term equity outperformance. Pension funds bought more and more equities because they kept outperforming. Insurance companies (except in the US, where their exposure has been limited by law) and retail investors went along for the ride. Figure 7 shows the annual returns from US equities and government bonds by decade. (Figures 5 & 6 are omitted)



From 1920 to 2010, even including the Great Depression and the dreadful experience of the last decade, US equities have generated a healthy annual return of 10.9% compared to 6.1% for bonds. The most spectacular equity performance was not in the roaring 1920s, 1980s or 1990s, but in the 1950s. It took many years for the wounds of the 1929 crash to heal; US equities did not exceed those levels for 25 years. From then, a 45 year love affair began. By the end of 1999, the long-term outperformance of equities over bonds looked truly spectacular. $100 invested in US equities in 1950 was worth $58,380 compared with $1,651 in treasuries.

What Now?

In the noughts (since 1999), global equities returned a trivial 4% with brutal volatility; two 50% bear markets in one decade was enough. Strong returns until 2000 helped to build the cult of the equity and weak returns are now reducing it. In 2009 US private sector pension funds held 55% of assets in equities compared to 70% in 2006. UK pension funds cut their equity holdings to 39% in 2009, down from the 76% high in 1993. A reduction to pre-1959 levels (around 20% assets) would imply a further $1,900bn reduction in equities for US private sector pension funds alone. The story amongst retail investors looks similar.

Citi believes that, from a valuation perspective, equities are likely to remain "cheap" against bonds for some time. Institutional investors are unlikely to go back into equities soon but appear to be adding to bonds. This is convenient for governments that have vast amounts of bonds to sell. Valuations will continue to reflect this situation with the Equity Risk Premium rising from the traditional 7% to more than 10%. No government can fund a trillion dollar bond bubble, and see equity allocations rise at the same time; this is why some commentators expect the S&P to get to the 400 range.