

A quandary from McQuarrie

Global Matters Weekly

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– Tom Delic — *Fund Manager*

The long run outperformance of equity markets versus all other major asset classes has become orthodoxy in the investment world. Widely read studies from the likes of Roger Ibbotson, Jeremy Siegel and Credit Suisse's Global Investment Returns Yearbook have cemented equities as an unequalled asset class for delivering the best long term returns for investors. Implications based on the above include the belief that investors with time horizons of 20 to 30 years or more can have a 100% allocation to equities, and the data presented in these studies seemingly provides the proof that this has been a particularly sweet pudding for investors to eat over the course of a century or more. While there appears to be sufficient evidence to support this recommendation, work over the past few years has placed this commonly held belief into question. At the risk of over-egging the pudding analogies, the equity soufflé has hit some cooler air and its rise has been thrown into doubt.

Edward McQuarrie, a retired university professor, has sought to both improve the quality, and extend the period of data used when analysing the returns of equities versus bonds. Key improvements include the expansion of coverage for both equities and bonds, thereby reducing survivorship bias, and calculating capitalisation weighted returns rather than price or equal weighted.

The first and perhaps most striking result of McQuarrie's analysis¹ is that equity and bond performance between 1792 to 1941 was roughly equal, a very different result compared to the vast outperformance of equities over bonds from 1942 onwards. Concentrating on a long-term time horizon should be encouraged, but the full periods measured in both eras are longer than most people would consider when saving for future expenditure*.

Siegel's case of 'Stocks for the Long Run', partly rests on shorter term performance, which demonstrates over 30-year rolling periods, equities have outperformed bonds

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90%² of the time, suggesting an aggressive allocation to equities is warranted for most long-term investors. However, McQuarrie's 227-year analysis indicates that while the odds of equity outperformance do increase as the period becomes longer, the extended periods of equity underperformance versus bonds across the 19th century mean the rolling 30-year odds only reach 67%. It is still strong case for preferring equities over bonds, but by no means a one-way bet over time periods that are meaningful for the average investor.

The sample data taken from a time when the world that looks very different to today's can easily be consigned to the annals of history. However, data outside of the US, also provides an alternative picture to the US biased analysis used by Siegel et al. McQuarrie's work finds multiple instances of 20- and 30-year negative real returns for non-US equities, along with underperformance versus bonds. There is no pattern within the data, with negative equity premiums observed across many individual countries, during the 19th, 20th and 21st centuries.

McQuarrie's analysis also shows the changing correlation between equities and bonds over time. Correlation over rolling 20-year periods reached their lowest ever (i.e. negative) levels in recent decades, very different to the 0.61 correlation recorded for the 134-year period from the beginning of the data set.

McQuarrie's contribution to the literature provides important new information for investors. By expanding

* Undrawn savings passed from one generation to the next is a valid counterpoint, but I believe the average saver tends to think of reaching pension age as a milestone in their investment journey.

Sources: **1** Edward F. McQuarrie (2023) *Stocks for the Long Run? Sometimes Yes, Sometimes No*, Financial Analysts Journal. **2** Siegel, Jeremy J. *Stocks for the Long Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies*

historical and international datasets, the relationship between equities and bonds, in terms of the former's assumed outperformance, and the correlation of returns between the two asset classes, is perhaps not as straightforward as other studies have implied. McQuarrie suggests a lack of stationarity exists, meaning there are no fixed statistical properties over time when it comes to asset class returns. One explanation cited for this is the Regime Thesis. This states that unlike the improvements made when increasing the sample size to measure the mean and standard deviation of say, height in a population, increasing the dataset through the addition of further historical data does not help to gain further confidence when analysing long-term asset class returns. Instead, temporary patterns,

or regimes, of asset returns occur. These can often be for extended periods, and can contain temporary stationarity, but this breaks down across multiple regimes. One broad lesson to take from McQuarrie's study is that it is always worth questioning investment convention. While the odds remain in favour of equities outperforming bonds over long time periods, it cannot be assured, and the possibility of being in an unlucky generation of equity investors should not be discounted. The good news however is that multi-asset portfolios can offer some protection, offering a balance between core asset classes such as equities and bonds, along with other avenues of returns from physical gold, and uncorrelated strategies such as trend following or long volatility.

The Marketplace

- Global equities rose 1.5%
- Middle-Eastern tensions rose against Yemen as the West targeted the Houthis, who continue to attack oil tankers in the Red Sea
- Brent crude fell 0.6% to \$78.29 barrel
- Gold rose 0.2% to \$2049.06 per ounce.

Market Focus

US

- US equities rose 1.9%
- USA is closed today for Martin Luther King day
- Bitcoin edged up after the SEC approved the launch of Bitcoin ETFs by organisations including BlackRock and Fidelity.
- USA CPI for December month-on-month was 0.3% (vs 0.2% expected), and initial jobless claims were 202k (vs 210k expected).

UK

- UK equities fell 0.7%
- UK police arrested six people over a plot to target the London Stock Exchange. Activists from the Palestine Action group were allegedly planning to cause damage and prevent the building from opening today.
- UK GDP for November month-on-month was 0.3% (vs 0.2% expected).

Europe

- European equities rose 0.2%
- Christine Lagarde said the ECB will start lowering rates once it's convinced inflation is headed back to its 2% goal.
- As Emmanuel Macron aims to revive his presidency with a new government, Gabriel Attal, previously education minister and only 34 years old, was named France's next prime minister.

Asia/Rest of The World

- Global emerging market equities fell 0.6%
- Japanese equities rose 4.2% despite being closed Monday for Respect for the Aged Day
- Bank of Japan officials are expected to discuss cutting their forecasts for inflation and growth when they meet this month, people familiar said. The officials are considering lowering their outlook for consumer price growth, excluding fresh food, to around 2.5% for the fiscal year starting in April.
- Chinese equities fell 1.8%
- Peoples Bank of China unexpectedly kept its critical medium-term lending facility rate unchanged at 2.5% while also pumping more cash into the financial system, defying expectations of a cut.

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Asset Class/Region	Currency	Currency returns			
		Week ending 12 Jan. 2024	Month to date	YTD 2024	12 months
Developed Market Equities					
United States	USD	1.9%	0.3%	0.3%	21.5%
United Kingdom	GBP	-0.7%	-1.1%	-1.1%	1.9%
Continental Europe	EUR	0.2%	-0.4%	-0.4%	9.8%
Japan	JPY	4.2%	5.4%	5.4%	34.0%
Asia Pacific (ex Japan)	USD	-0.8%	-3.2%	-3.2%	-2.3%
Australia	AUD	0.1%	-1.2%	-1.2%	7.4%
Global	USD	1.5%	0.0%	0.0%	18.4%
Emerging markets equities					
Emerging Europe	USD	1.7%	1.2%	1.2%	28.4%
Emerging Asia	USD	-0.8%	-3.1%	-3.1%	-2.4%
Emerging Latin America	USD	-0.7%	-2.3%	-2.3%	20.4%
BRICs	USD	-0.5%	-1.9%	-1.9%	-6.5%
China	USD	-1.8%	-4.4%	-4.4%	-23.1%
MENA countries	USD	0.6%	2.0%	2.0%	7.0%
South Africa	USD	0.1%	-5.3%	-5.3%	-11.8%
India	USD	1.2%	1.2%	1.2%	21.4%
Global emerging markets	USD	-0.6%	-2.7%	-2.7%	0.4%
Bonds					
US Treasuries	USD	0.7%	-0.3%	-0.3%	1.2%
US Treasuries (inflation protected)	USD	1.0%	0.1%	0.1%	1.7%
US Corporate (investment grade)	USD	1.2%	-0.1%	-0.1%	4.6%
US High Yield	USD	1.0%	-0.1%	-0.1%	9.1%
UK Gilts	GBP	-0.4%	-2.3%	-2.3%	-1.3%
UK Corporate (investment grade)	GBP	0.1%	-1.5%	-1.5%	4.5%
Euro Government Bonds	EUR	0.0%	-0.7%	-0.7%	2.9%
Euro Corporate (investment grade)	EUR	0.3%	-0.6%	-0.6%	5.5%
Euro High Yield	EUR	1.0%	0.5%	0.5%	10.1%
Japanese Government	JPY	0.4%	0.6%	0.6%	1.7%
Australian Government	AUD	0.4%	-0.5%	-0.5%	1.4%
Global Government Bonds	USD	0.3%	-1.1%	-1.1%	0.1%
Global Bonds	USD	0.4%	-0.9%	-0.9%	2.2%
Global Convertible Bonds	USD	0.1%	-1.7%	-1.7%	3.9%
Emerging Market Bonds	USD	1.1%	-0.9%	-0.9%	6.2%

Source: Bloomberg. Past performance is not indicative of future returns

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Property					
US Property Securities	USD	1.2%	-0.5%	-0.5%	4.7%
Australian Property Securities	AUD	1.9%	-1.6%	-1.6%	6.6%
Asia Property Securities	USD	0.3%	-2.0%	-2.0%	-7.6%
Global Property Securities	USD	0.8%	-1.1%	-1.1%	3.3%
Currencies					
Euro	USD	0.0%	-1.0%	-1.0%	0.9%
UK Pound Sterling	USD	0.1%	-0.2%	-0.2%	4.2%
Japanese Yen	USD	-0.1%	-2.8%	-2.8%	-10.9%
Australian Dollar	USD	-0.4%	-2.2%	-2.2%	-4.1%
South African Rand	USD	0.1%	-2.1%	-2.1%	-10.3%
Swiss Franc	USD	-0.4%	-1.7%	-1.7%	8.8%
Chinese Yuan	USD	-0.3%	-0.9%	-0.9%	-6.1%
Commodities & Alternatives					
Commodities	USD	-0.6%	-0.1%	-0.1%	-3.9%
Agricultural Commodities	USD	-0.3%	-1.6%	-1.6%	-0.1%
Oil	USD	-0.6%	1.6%	1.6%	-6.8%
Gold	USD	0.2%	-0.7%	-0.7%	8.0%

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