

INVESTING: THE LONG AND THE SHORT OF IT

Should the 'long term' now be measured in years, decades or months?

JULY 2009

AT A GLANCE

- The 'long term' is used commonly in investment circles. There is doubt as to what the term actually means
- A definition of 'the long term' will depend as much on personal experience as investment returns

“Imagine the stock market is a beach: the price waves are either getting larger and larger...or the sets are coming faster and faster”

‘Over the long term’ is one of the two standard investment commandments: diversify risk, and remain invested over the long term. It has been and is used by many in the investment management community and has been particularly prevalent in the past 18 months when short-term returns have looked dour. But what exactly is the long term? Should the ‘long-term’ now be measured in years, decades or months? Let the debate begin.

The long term may be the general length of a business cycle, say seven years, or in the case of many equity funds three to five years. Typically, the assumption behind 'long-term investment' is that it is the period where an investor can be confident they are not going to lose their capital, i.e., when a market's beta risk has been diversified away by the passage of time and the general upward movement of the market.

But what we have learned over the past two extraordinary years is that an indicator of how long an investment has to be held before it can virtually be guaranteed to give a positive return can no longer be measured by years. For the unlucky investor, it may have to be measured in decades.

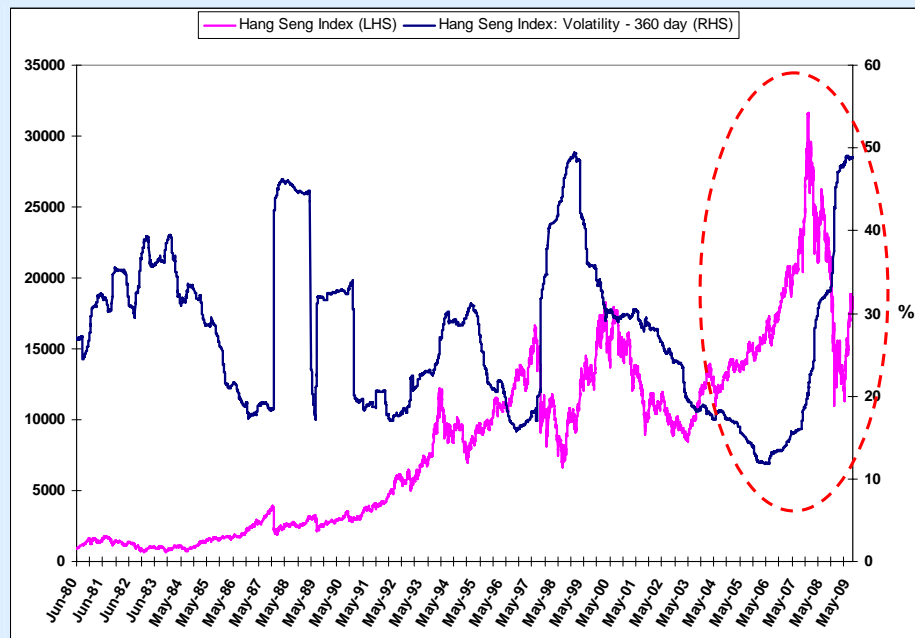
Japanese equity investors had what has been termed the 'Lost Decade', from 1990 to 2000, but a plural could now be satisfactorily applied to the moniker. Since 1990, the Nikkei 225 has lost 77.3% even while the amount of money in the economy has continued to slowly rise. This was thought to be something unique to the Japanese market, affected by ineffective politicians and slumping margins as electronics became commodities and the yen refused to stay low.

But now the Lost Decade or at the least the Lost Years can be just as aptly applied to US and other equities markets. After the 1994 – 2003 period (where stock markets arguably became overvalued) annual total returns for the MSCI AC Asia Pacific index have come in at 2.3%. For the Standard & Poor's 500 the equivalent number is -2.0%. Over the past ten years the S&P 500 has returned -1.9% annually.

If you cherry pick time periods, the story can be more expensive. Since the beginning of 2006, the total returns for the S&P 500 come to an annual -6.4%¹. Does this mean that the 'long term' is at least longer than three years, which to many investors is the long term when they look at any managed fund? Or is it therefore longer than a decade – the period of negative returns for the globe-leading US market?

There are two possible answers – one is that the long term is getting longer, or another that says the long term is getting remarkably shorter. Imagine the stock market is a beach: the price waves are either getting larger and larger, and hence the lull between them becoming perceptively more dangerous, or the sets are coming faster and faster, meaning the investor has to be fleet of foot to avoid taking a bath.

SINCE 2005 VOLATILITY HAS REACHED ITS HIGHEST POINT SINCE THE 1999 CRISIS



For example, a 28-year history of the Hang Seng Index shows that volatility has remained relatively trend-free over the long term, averaging an annual 20% and 30% over that period around a mean 27.4%¹. However, since 2005 (circled) volatility has jumped markedly to now be closer to 50%. Although the 28-year duration would tend to support the theory that longer period volatility has not risen in the market, anyone who has invested solely in the 21st century when volatility has increased sharply would certainly be allowed that opinion.

On the other side, the up and down wavelengths of the market do tend to be shortening. Due to the power of instant communications, faster government reactions to economic woes and the proliferation of leveraged players like hedge funds which accentuate movements, 'microwaves' like that seen in the period 1997–2003 are becoming more major in impact. Or, as David Viniar, Head of Quantitative Strategies at Goldman Sachs, said in late 2008: "We are seeing 25-standard deviation moves, several days in a row." A 25 standard deviation event can be expected to happen once every billion years or so. When he was speaking, these events were happening on a daily basis.

Whatever we agree on the technical aspects, the 'long term' will continue to remain a debatable concept, particular in these volatile times. The key point is 'long term' for a 55-year old is very different to that of a 19-year old and that's the point we should be focused on – it's not the state of the market that matters, it's the state of the investor.

Source:

1. Bloomberg as of 1 July 2009

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