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# Stock Markets and Investment Options

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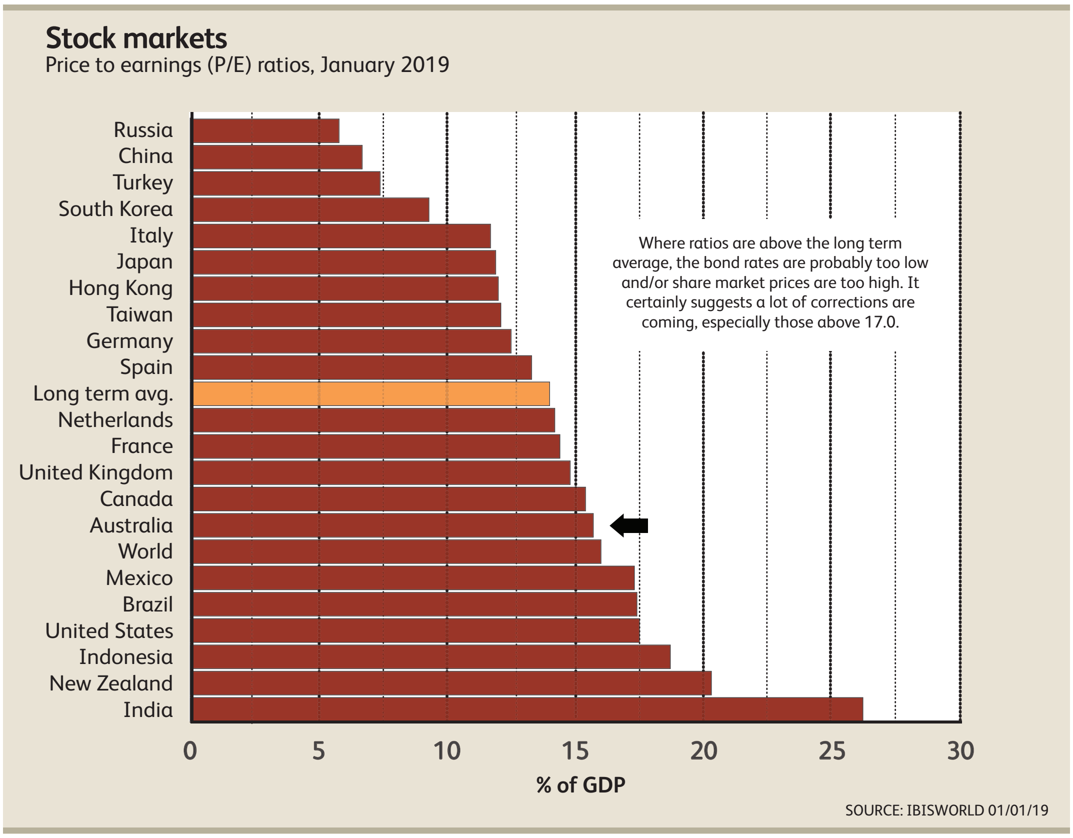
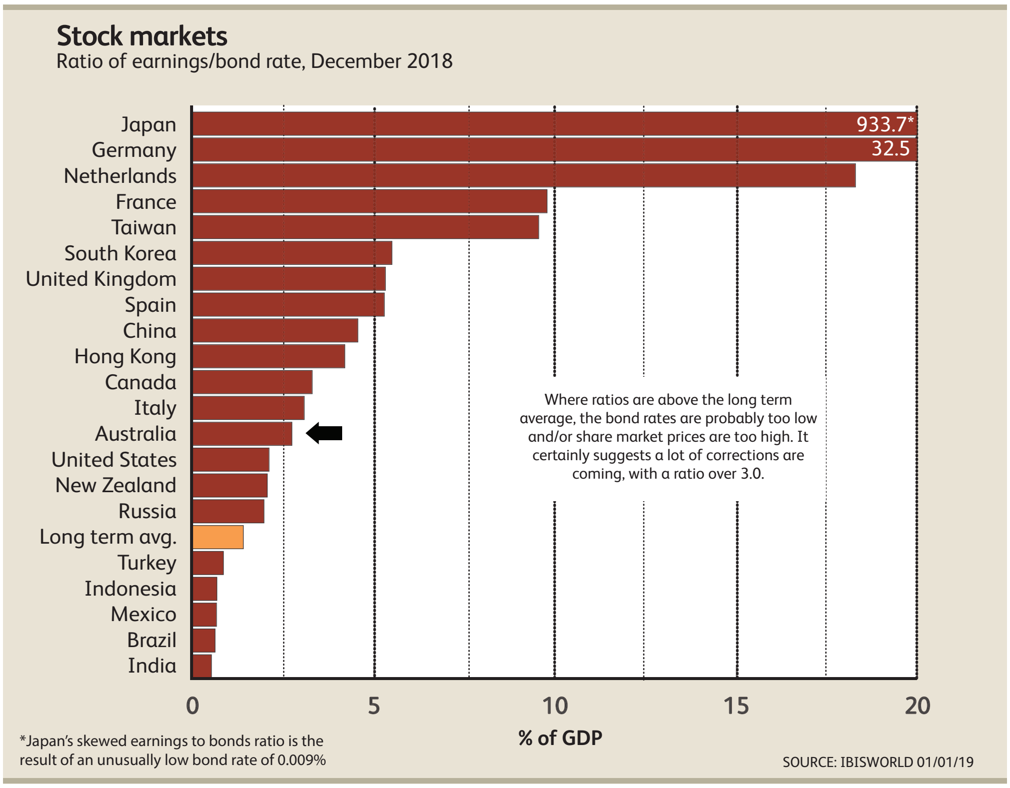
When it comes to stock markets, we would all like to know whether they are going to go up, boom, stabilise, fall or crash. October is one of those legendary months when particularly nasty crashes have occurred, all the way back to 1929. But not every year!

The two charts below provide contemporary perspective: the first compares price/earnings ratios across 21 countries, and the second compares the earnings/price rate as a multiple of 10-year bond rates.






In the first chart, many countries have a P/E ratio above the long-term average of 14/1. This is largely the result of record low bond rates and the aftermath of the GFC in 2008. For these countries to move towards a lower average, earnings would have to significantly grow while stock prices remain static, or stock markets would have to significantly fall over time. The sharp stock price declines throughout October and late December suggest that the latter is more likely.

The second chart is more useful. It tells us the ratio of earnings on stock market prices compared with the 10-year bond rate. Ratios that are above the long-term ratio suggest that the bond rates are too low or share market prices are too high.

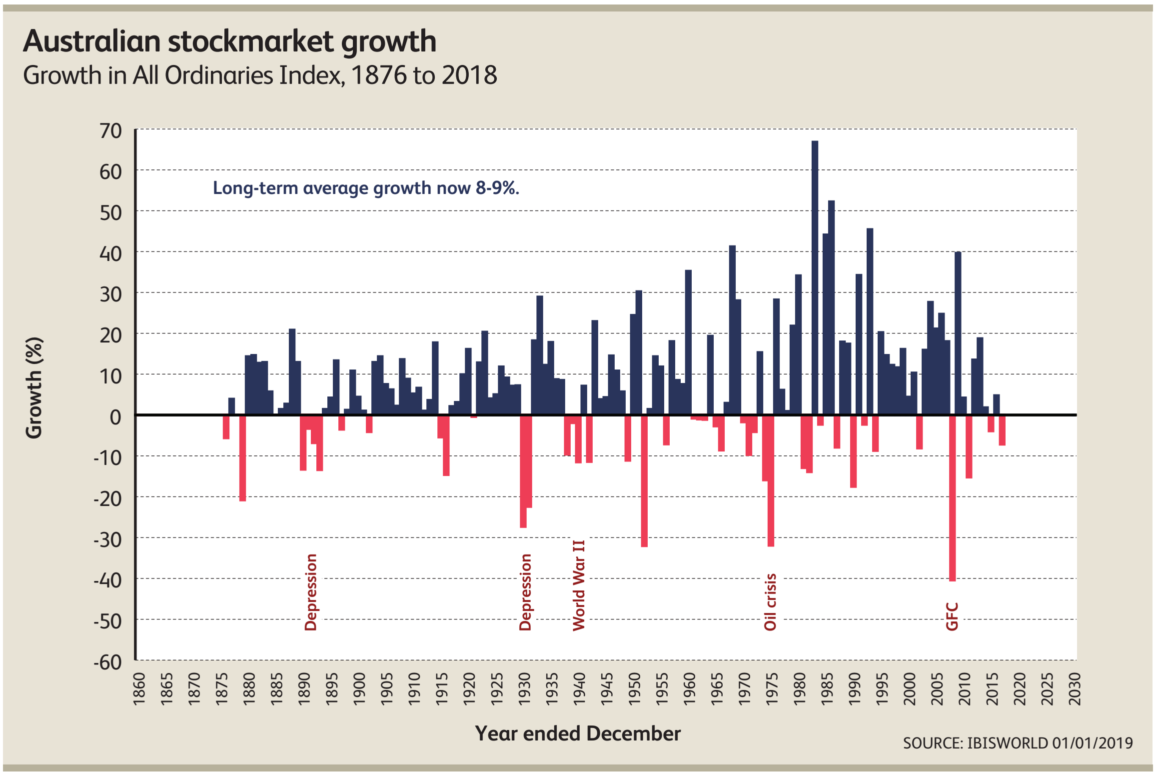
If stock market prices fall while bond rates are still rising back to normal levels, then the ratio will simply correct back to normal more quickly; that is where there is the danger of recessions. This cannot be ruled out, especially with aberrant developments such as trade wars, massive deficits by governments, and climbing national debts adding fuel to the fire, so to speak.

So, it is useful to see what has been happening to our Australian stock market over time, and the returns on our investment asset choices.

When superannuation funds advertise in the media these days, they are obliged to add "past performance is not a reliable guide to future returns".

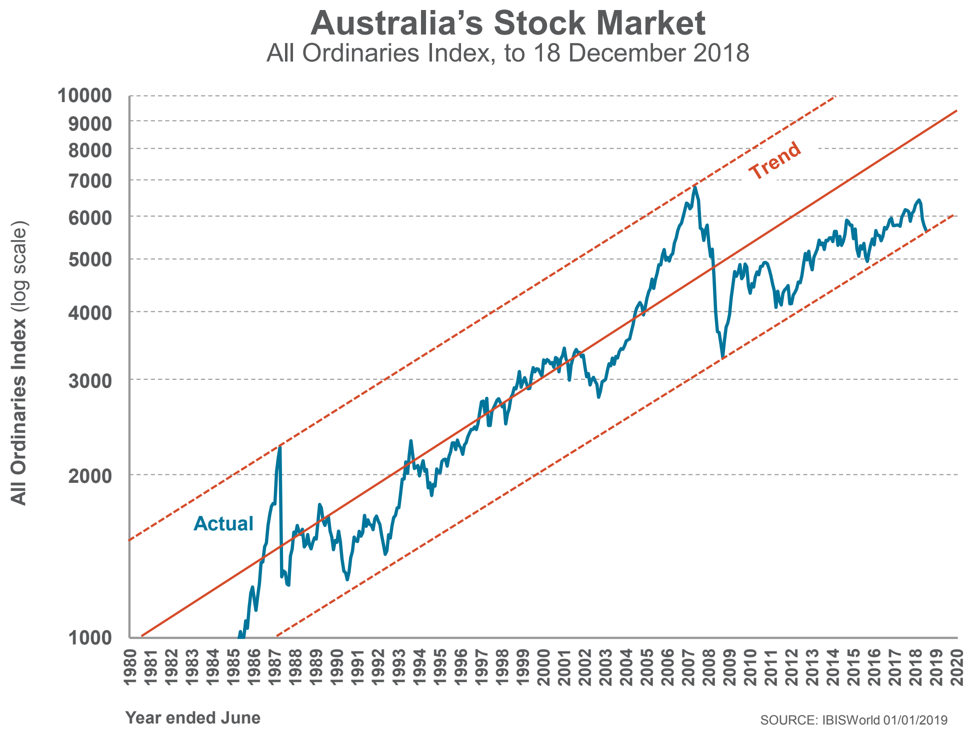
This is certainly true on a year by year basis, where the pecking order of asset classes and the pecking order of fund manager performance are somewhat volatile. Indeed, when it comes to asset classes, it is rare for the same class to top the ladder year to year.

The volatility of Australian shares over the past century and a half is evident in the chart below.




Indeed, the amplitudes of the rises and falls are alarming. Of solace is the fact that the All Ordinaries Index continues to climb, and the combination of dividends and capital gain has been rewarding to long-term investors for a long time.

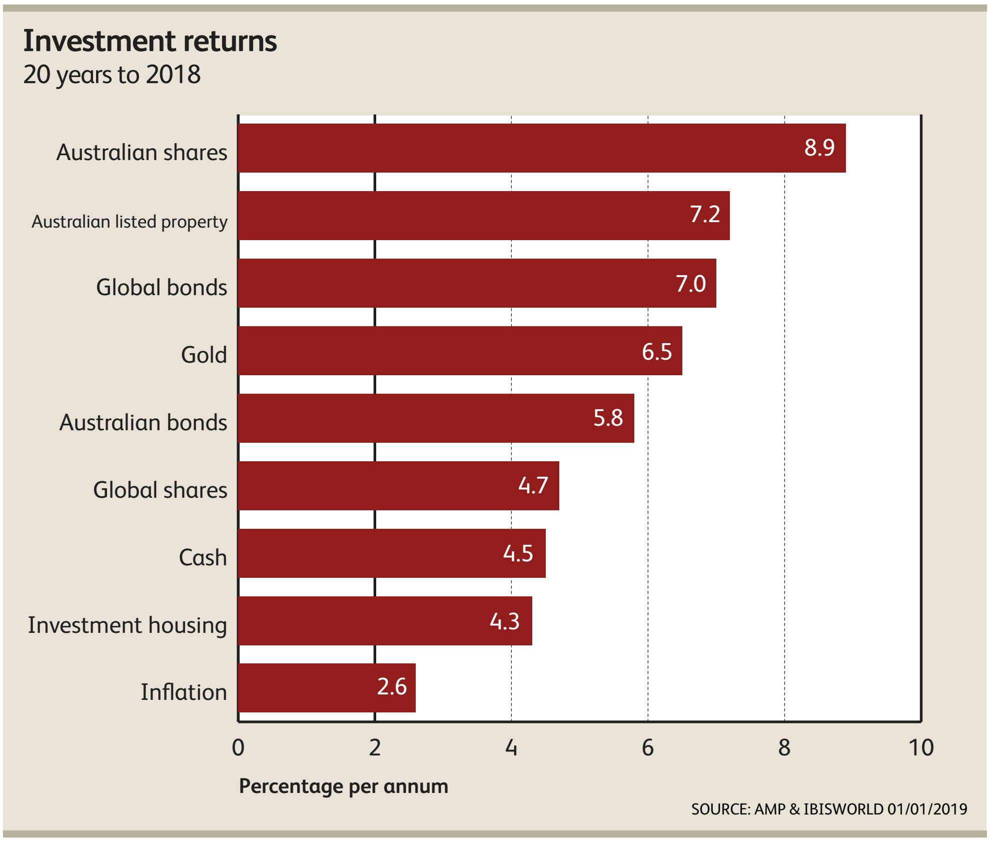
The All Ordinaries' behaviour over the past four decades is a reminder of this ongoing volatility, but also the possibility (if not probability) of it reaching the 7,000 mark within several years.




So, what are our choices when it comes to investments? The main asset classes are:

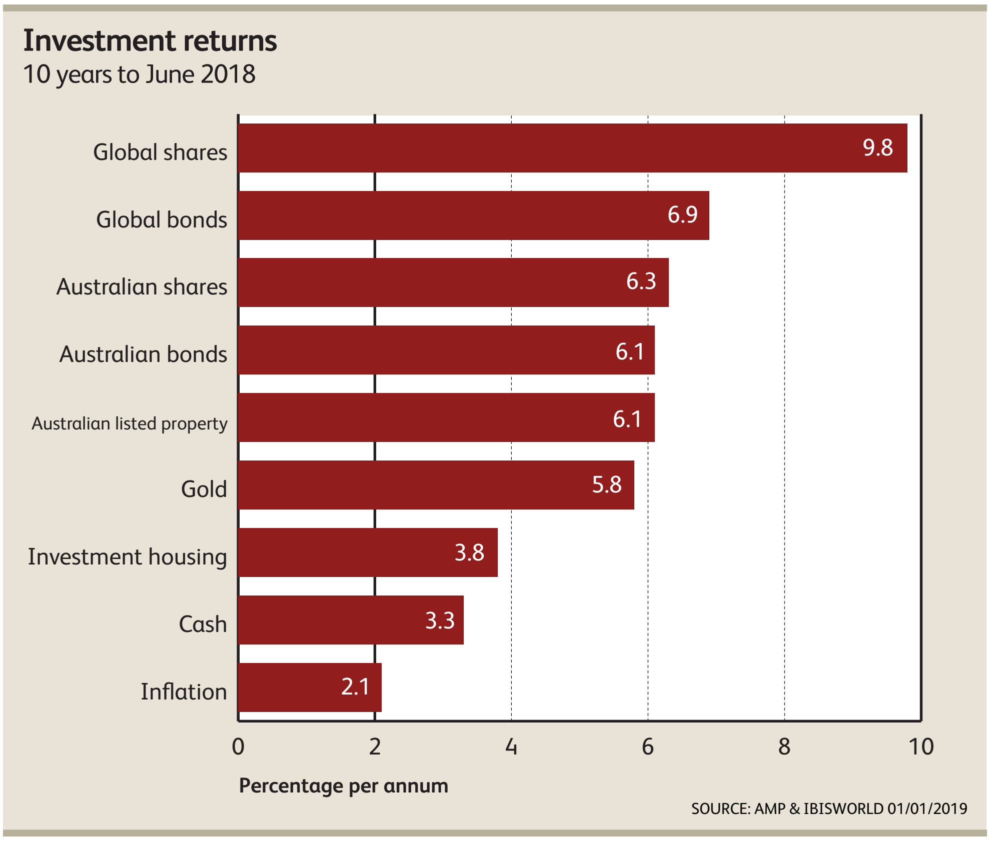
Shares (local and international)
Property (real and trusts)
Dwellings
Bonds
Cash
Precious metals (gold, silver, gemstones etc.)
Collectables (art, stamps, vintage cars etc.)

How have these performed over time? The following charts show the returns over 20 and 10 years.



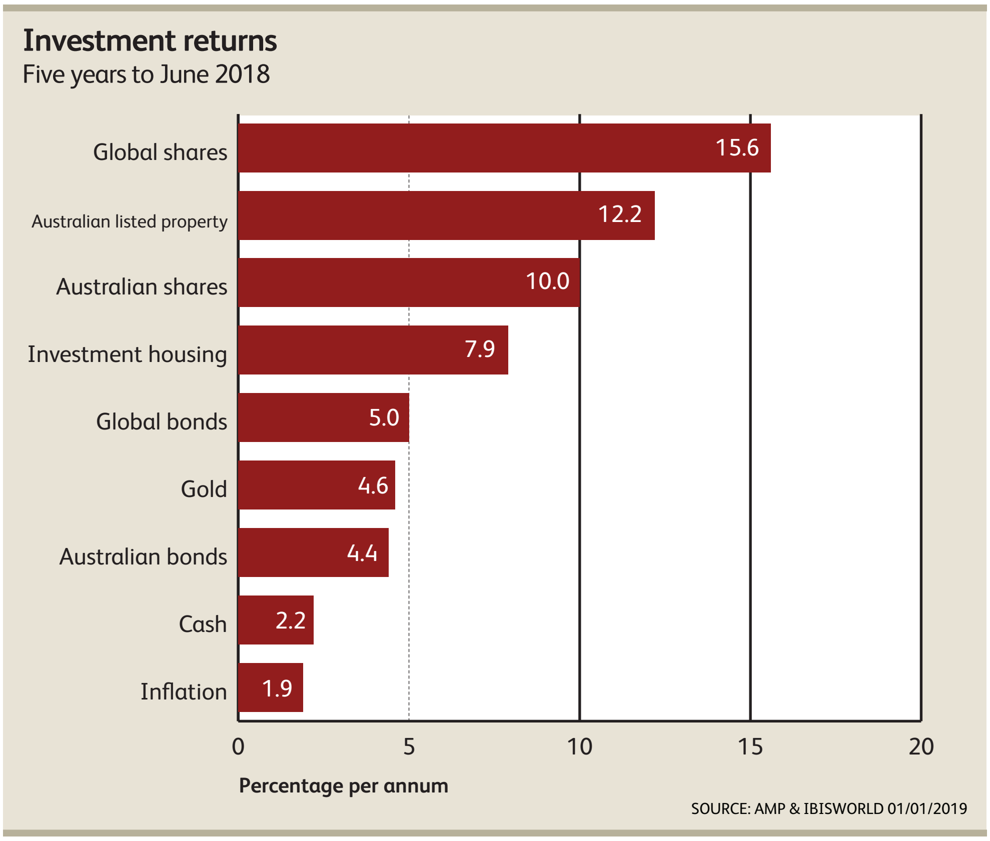

While active assets (shares) should always yield better returns than passive assets (bonds, property, collectibles and precious metals), that is not always the case. Global shares in the 20 years since 1998 were affected by the dot.com bubble and meltdown in 2000, and the GFC in 2008. Less so Australian shares that missed out on both crashes. Gold did much better than usual, as it is a panic metal these days and a perceived safe-house over this period.

The past 10 years show a different story, as we see below.




Global shares did best, with Australian shares in third place. Listed property has done well over both time periods. Gold resumed its normally low position, along with investment housing, which consistently performs poorly over long periods.

However, when we take a short period – say five years, as shown in the last table – and combine it with some extraordinary developments, some surprises emerge.




Firstly, global shares have done extraordinarily well in an environment of record-low interest rates. But with P/E ratios nudging 20/1 (compared with a safer 14/1) across the world (and some nations higher) alarm bells have to be ringing for the next five years. Investment dwelling prices and returns in Australia have also performed well, but may become a cause for concern. Sydney has experienced bubble prices, accompanied by one of the highest mortgage debt/GDP ratios in the world.

That said, shares and listed property classes seem to be the consistent best performers over long periods. Perhaps online shopping could dent listed property returns in the future.

However, if shares (being the only active-class investment) don't stay at or close to the top, the economy risks a depression caused by an asset crash from excessive exuberance or underperforming businesses.

Fund managers and SMSFs usually choose to be conservative by having over half their funds in active assets, yet take out insurance through other assets and cash. Just in case.

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