Short-term, shares may go down

- *Investors should have a plan for what they will do when it happens*

January 2020

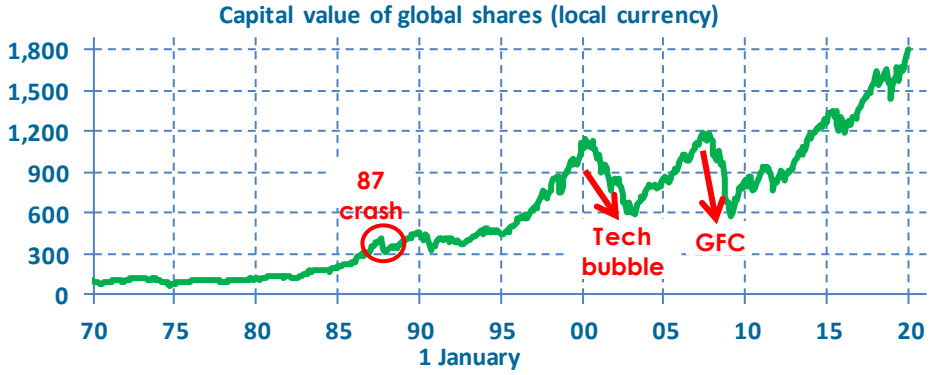
With shares, investors receive returns made up of dividends and the fluctuations in the capital value. They fluctuate day to day, month to month, quarter to quarter and year to year, around a path that is generally upward. Going down is always about when, not if. Also, at some point, the capital value of a diversified share portfolio will decrease significantly and stay down for several years, before it recovers.

When an investor who has cash flow liabilities invests in shares, they need to have a plan for how they will meet the cash flows in periods while the value of the shares is down. The investor may be an individual meeting their expenditure in retirement, net of New Zealand Superannuation, or a charity making regular grants to community organisations. The plan needs to ensure that the investor captures the long-term return advantage that shares offer, can still meet the budgeted cash flow liabilities and is comfortable that they will continue to be able to achieve their objectives.

History suggests that shares will, at some point, fall

History

Over the last 50 years, the global share markets have halved in value on two occasions. $1 became 50 cents, but the 50 cents recovered and ultimately increased beyond $1. Also, they have decreased by more than 20% on four occasions.



Shares do fall

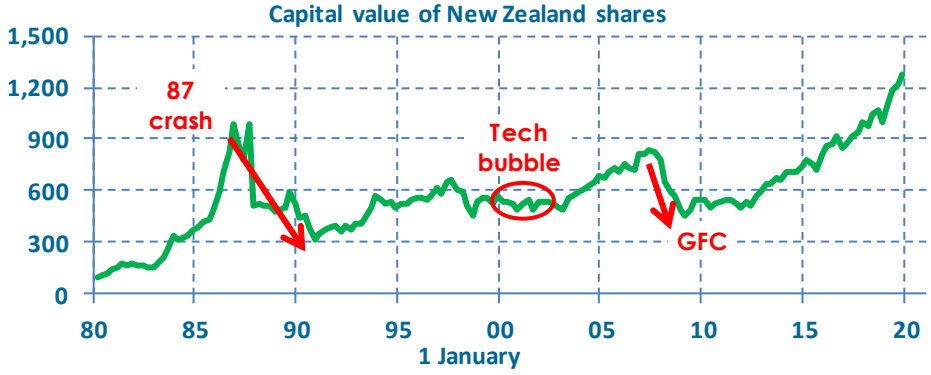
Shares do recover

History repeats

Having time to be wrong is crucial

Source: MSCI, MCA

Note, the 1987 share market crash was not as severe in the global markets as it was in New Zealand, where it decreased by more than 50% and did not fully recover for 30 years. Likewise, the tech bubble crash was not as severe in New Zealand as it was in the global markets, where it decreased by more than 50%. The capital movement of the New Zealand share market has beens:



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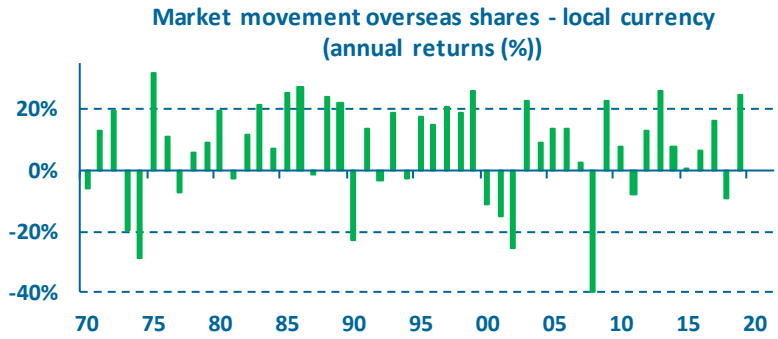
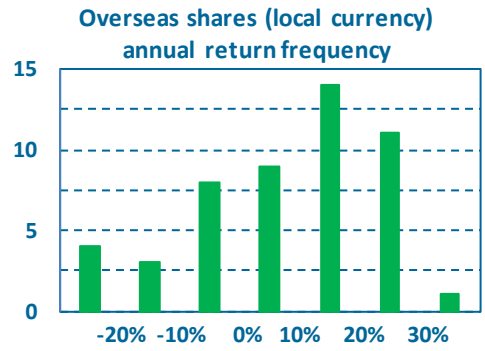
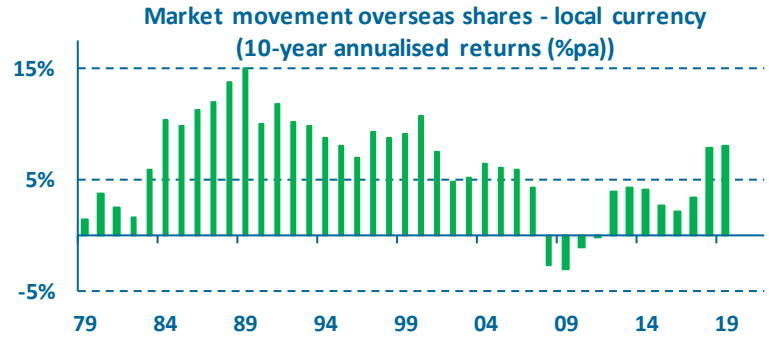
The pattern of annual returns from capital movements of the global markets since 1970, ie excluding dividends, have been:

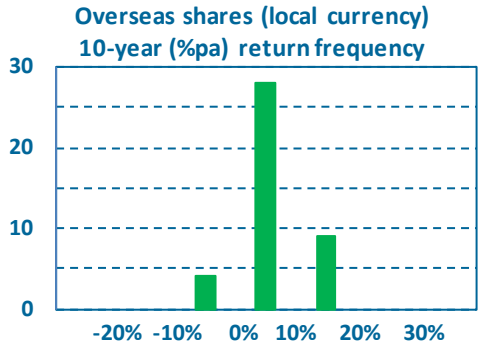




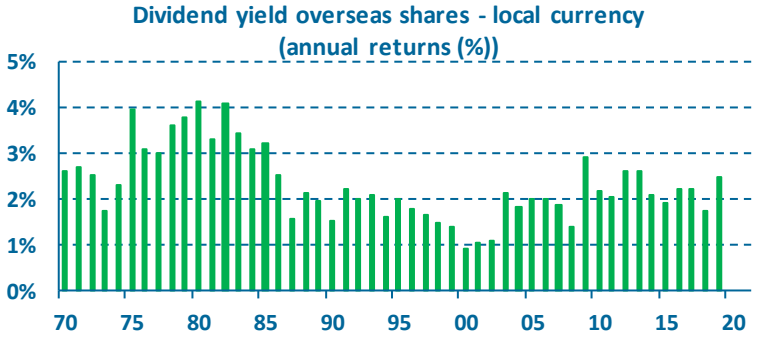
The graph to the right shows the frequency of the returns between different bands. For example, there were four periods where the return was less than -20% in a year.

The above graphs highlight that shares go down over a 12-month period, about 1/3rd of the time (15 times in the last 50 years) and the pattern of negative returns is random. Shares, however, should not be bought for a one-year period and are normally better suited for expenditure/cash flow liabilities that occur beyond 10 to 12 years. But average returns over 10-year periods are not always positive.



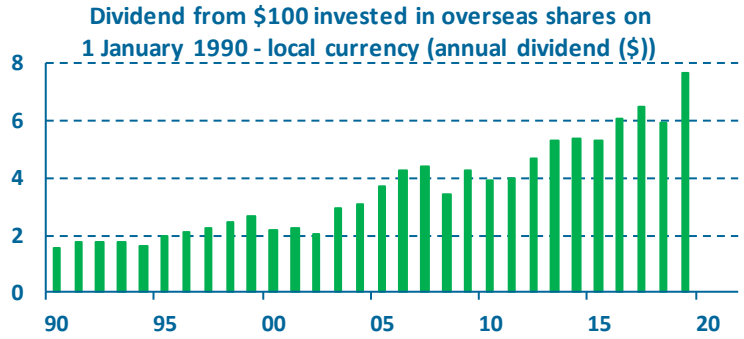


Note, the above are the capital returns. In addition, investors received returns from dividends. The annual dividend yields, as a percentage of the share price, have been:



In many cases, the return from the current dividends and the projected dividends is the more important return. The market movement leads, over time, to a higher market value, which in turn ultimately leads to higher dividends, in dollar terms, even if dividends are same in percentage terms.

If $100 was invested in overseas shares on 1 January 1990 (ie 30 years ago), the dividends flowing from the $100 (which is now worth $387 (despite two periods with a decline above 50% in the 30 years) would have been:



The graph shows that over the long term, the actual dividends have trended upwards.

Looking forward

In the next 50 years, there is no reason to expect that shares won't, at some point, 'halve' again. In fact, it will probably happen 2 to 3 times. We don't know when it will happen, but we can be confident that it may happen. What is the plan for when it happens? Do you reduce the budgeted expenditure? Do you sell some shares at a loss? Do you allocate some capital to cash and spend that? The best plan lets you ignore it, because it is only temporary, and you have no need to realise (ie sell) the shares before they recover? The better plan should be based on the principle of not being forced to sell, ie having appropriate cash available.

Shares go down every 3 to 4 years on average

To sell or not to sell

In response to a fall, there is normally little point in selling. It does not make sense to plan to sell, after the shares have gone down, unless there is a belief they will go down further. Also, as no one knows in advance when they are about to go down, you cannot plan to sell in advance, unless you sell now. If you sell now, you miss out on the gains between now and when they eventually fall. This may be significant and is illustrated by the experience in New Zealand in the 80s. Had shares been sold in 1985, when the market also looked very expensive, investors would have missed out on the next two years' returns totalling 150.1% (ie 58.2% a year). The 87 crash saw only part of those returns disappear.

This leads to the question, "why were the shares bought?" If it was for long-term growth, that objective still remains valid and on track, despite a short-term temporary, but major, fall. If it was for high short-term returns that could be realised to meet the cash flows, that objective should be thought through, as shares do not go up each year and typically go down, on average, 1 year in 3 to 4.

The plan therefore, has to be centred around being able to continue to hold the shares until they recover. The secret to waiting, is to ensure that you can still meet the short-term cash flow objectives from the dividends received and the other assets (eg cash). If you can't, then there may be merit in holding a lower exposure to shares. The important fiduciary principle is to decide today what you will do if the shares halved tomorrow.

In principle, investors should decide before it happens, ie have a plan, but reserve the right to review the decision when it happens, based on the actual environment at the time.