Taking risk in a risk-off environment

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Investing in equities fundamentally involves assessing their risk premium - the expected return over fixed interest investments. This measurement is essential, as equities need to offer a higher return for the additional risk. Historical data, as shown in Table 1, demonstrates that long-term investors have consistently favoured equities due to their substantial returns above inflation compared to fixed income options.

Table 1**:**

Annualised return in ZAR above inflation: 1940 - 2019	
Developed Markets Equities	6.33%
SA Equities	6.80%
SA Bonds	1.01%
SA Cash	0.60%

Source: Morningstar, 31 December 2019

Is this time different?

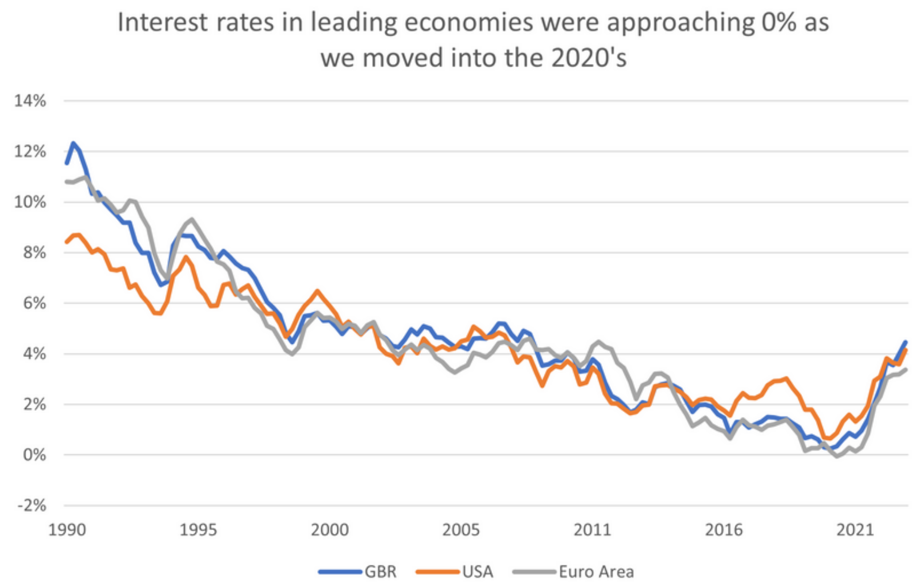
The decade from 2010 has been eventful with significant economic and geopolitical developments like Brexit, Trump's tariffs, and political turbulence in South Africa. In spite of this, investments in equities held firm. This was partly due to returns remaining relatively strong, but more importantly – there was simply t no alternative. With global interest rates at near record lows, moving to fixed interest did not provide a sufficient return on one's investment. Graph 1 illustrates the downward trend of interest rates over the decades.

As we close the third year of the 2020's, it is probably fair to say that we have already experienced more volatility in these three years than what was expected for the entire decade.

The current economic environment of stubborn inflation, high interest rates and worrying amounts of geopolitical tension in Europe, the Middle East and Asia have erased the memories of strong returns during 2021.

Worried investors are once again looking for alternatives to equities and this time they have options. Due to high rates, fixed interest looks very appealing. In the US you can get a long-term bond with a yield of over 5%, while in South Africa it currently stands at 12.9%. Historically this would not necessarily be enough to lure investors en masse, but many are wondering – is this time different? After all, the phrase 'new normal' became a household saying during COVID.

Graph 1:



Source: Morningstar, 31 December 2019

Sticking with equities

While the current economic environment may seem rather bleak, the prospects for strong future equity returns are much better today than at the beginning of 2022. The relatively poor equity returns over the past 18 months has lowered the bar for higher potential future returns. In their annual report on expected future returns, JP Morgan increased their expectations for US large-cap stocks from 4.1% to 7.9%, over the next 10 - 15 years. They noted that: "lower valuations and higher yields mean that asset markets today may offer the best long-term returns in more than a decade."

While short-term volatility is likely to continue, this appears to be an attractive entry point for long-term investors and not necessarily a good time to de-risk one's portfolio. The appropriate level of risk taken in any investment portfolio should always be directly linked to an investors' goals and the time horizon available to achieve those goals. Making changes based on short-term volatility is the fastest way to derail an investment plan.

The way forward

The most sensible way forward is to ensure that one's portfolio is well diversified and is being managed by professionals that know what they are doing. The prudent approach is to ensure a well-diversified portfolio, managed by experts. As a multi-manager, PPS Investments is committed to this strategy. We engage top managers from across the globe, leveraging their diverse investment styles, expertise, and geographic insights. This enables us to craft diversified solutions aiming for strong long-term, risk-adjusted returns, embodying our belief that "With us, the investment is mutual."

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