PHILO CAPITAL ADVISERS

Gains lose lustre in the cold light of inflation

Market monitor

Philip Baker

Any investor celebrating this week when the All Ordinaries Accumulation Index edged past its November 2007 peak to reach a fresh high might want to put away their party hat. For all the talk about the power of dividends and compounding interest, they are still out of pocket.

Why, you might ask? Inflation.

He might be a bit of a killjoy but Ashley Owen, joint chief executive of Philo Capital Advisers, points out that total returns are just academic and it normally takes a lot longer than six years to claw back any losses from a major sharemarket crash.

He argues that investors need to know more about returns once inflation is taken into account because often dividends don't get reinvested as retirees need them to help pay for their living expenses.

To illustrate the issue facing investors, Mr Owen says the current All Ords, about 5200, would need to rise another 32 per cent to reach its November 2007 peak level of 6853.

But once inflation is taken into account the November 2007 peak target is closer to 7900 and climbing steadily with inflation. That means shares need to rise by another 50 per cent from current levels to get back to the inflation-adjusted peak.

"If that takes another say three years to achieve, then that's three more years of inflation of, say, 2.5 per cent each year," Mr Owen says.

"That raises the target by another 8 per cent, which means it would require a rise of 64 per cent from today's level to achieve over three years. That's a big ask."

The accompanying graph from the Cuffelinks website also shows there's been more than just a few major collapses over the past 100 years.

And Mr Owen says it's important to study peak-to-recovery performances because retail investors often buy in at the peak. For example, in 2007 the government's $1 million window for lump superannuation contributions lured many new buyers into shares.

Indeed, the graph shows it has twice taken 30 years or more for shares to recover after a large sell-off.

In fact, the All Ordinaries today is barely above its August 1968 peak in real terms after inflation. That's not much return for 45 years.

A quick look at what stocks dominated the index back then shows some familiar names.

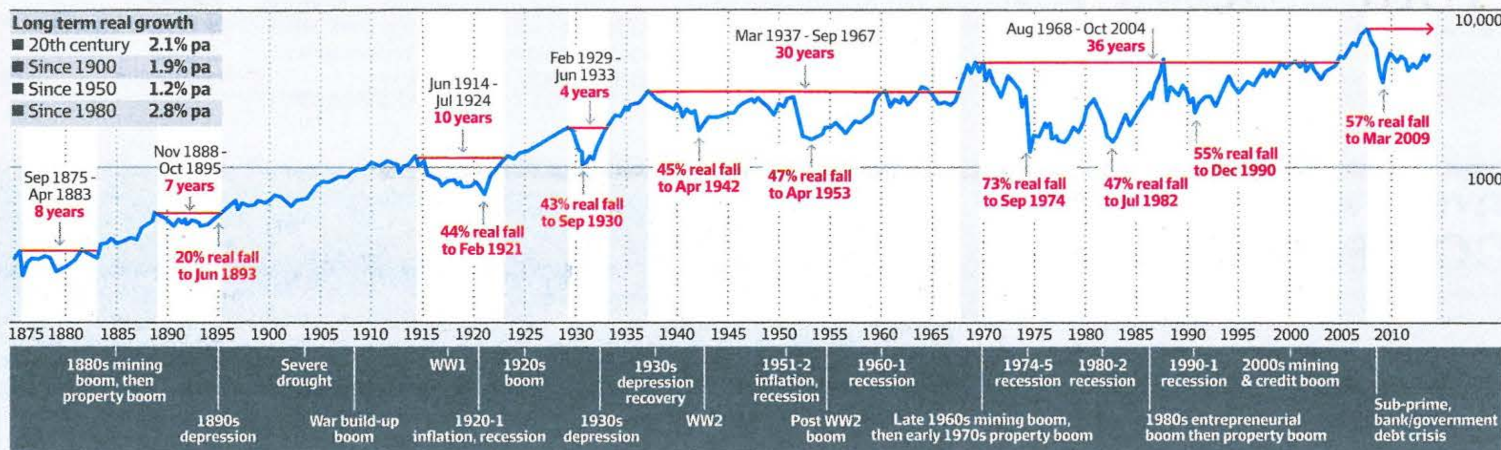
"Of the big-cap stocks in 1968, the share prices of Bank of NSW [Westpac], BHP, AGL, Woodside and QBE are all less than 3 per cent per annum ahead after inflation, and after adjusting for capital structure changes," Mr Owen says.

However the share prices of ANZ, NAB, CRA (RIO), Santos and Lend Lease are all still below their 1968 boom-time highs – after 45 years.

"That's 45 years to wait just to get back to square one after inflation, let alone any real capital growth for those who bought in the boom," he adds.

It might even be worse than that as many investors haven't just stuck to the boring big stocks at the height of booms, with many into speculative hot stocks that blew up. Owen says it's always been a long, long wait for those who bought in the boom.

"Investors who bought the 'time-in-the-market' and 'buy and hold' myths and the 'efficient markets' hocus pocus will have a very long wait indeed," he says. And that's before even realising that most fund managers fail to beat the broad market index after taxes and fees.



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