WHY EQUITIES

By Teh Hooi Ling CFA

2013

TO Warren Buffett, the world's most successful stock investor, investing is about foregoing consumption now in order to have the ability to consume more at a later date. So it follows that when we invest, our aim is to buy an asset whose price will grow faster than inflation over time. What makes the price of an asset grow? Well, when it can continually deliver output that more than covers its costs.

Demonstrably, the one asset class which has been able to do that over the long term is equities.

Here are the numbers.

It was end March 1980. Brothers Ah Beng and Ah Long had just inherited about $86,000 each from their father. Since both brothers already owned the roof over their heads, the father's instruction was that the money should be invested in things other than real estate.

Ah Beng is more conservative. He is very loss-averse. He fears losing his inheritance when the stock market crashes. After all, he saw for himself how the Singapore market plunged by 75 per cent between early 1973 and end 1974. And even at the beginning of 1980, the market was still some 40 per cent below its early 1973 levels.

Better be safe than be sorry, he reasoned. So he opted to put that $86,000 in a fixed deposit and to live off the interest the money earned. Let's be generous and assume that he managed to lock in a 33-year fixed deposit that pays him 5 per cent a year. So he has been receiving $4,300 every year for the past 33 years.

Ah Long, meanwhile, is more business-minded. He understands how the economy works. And he knew that he needed to grow the purchasing power of his inheritance if he were to be able to send his daughter to Harvard University 20 years later. He also understood that the best way to grow his money was to invest in businesses that can generate profits over the long term. But he had no time to do research on the stocks listed on the stock market at that time. So he decided to take a diversified approach, and to put $5,000 each into 17 stocks which were traded on the Singapore stock market then. (There is definitely a survivorship bias at work here, in that these 17 companies are the ones which survived up till today.)

How have Ah Beng and Ah Long done over the years?

Well, in the first nine years after they invested the money, Ah Beng who put his money in fixed deposit was getting more income in interest than Ah Long from his dividends. As mentioned, Ah

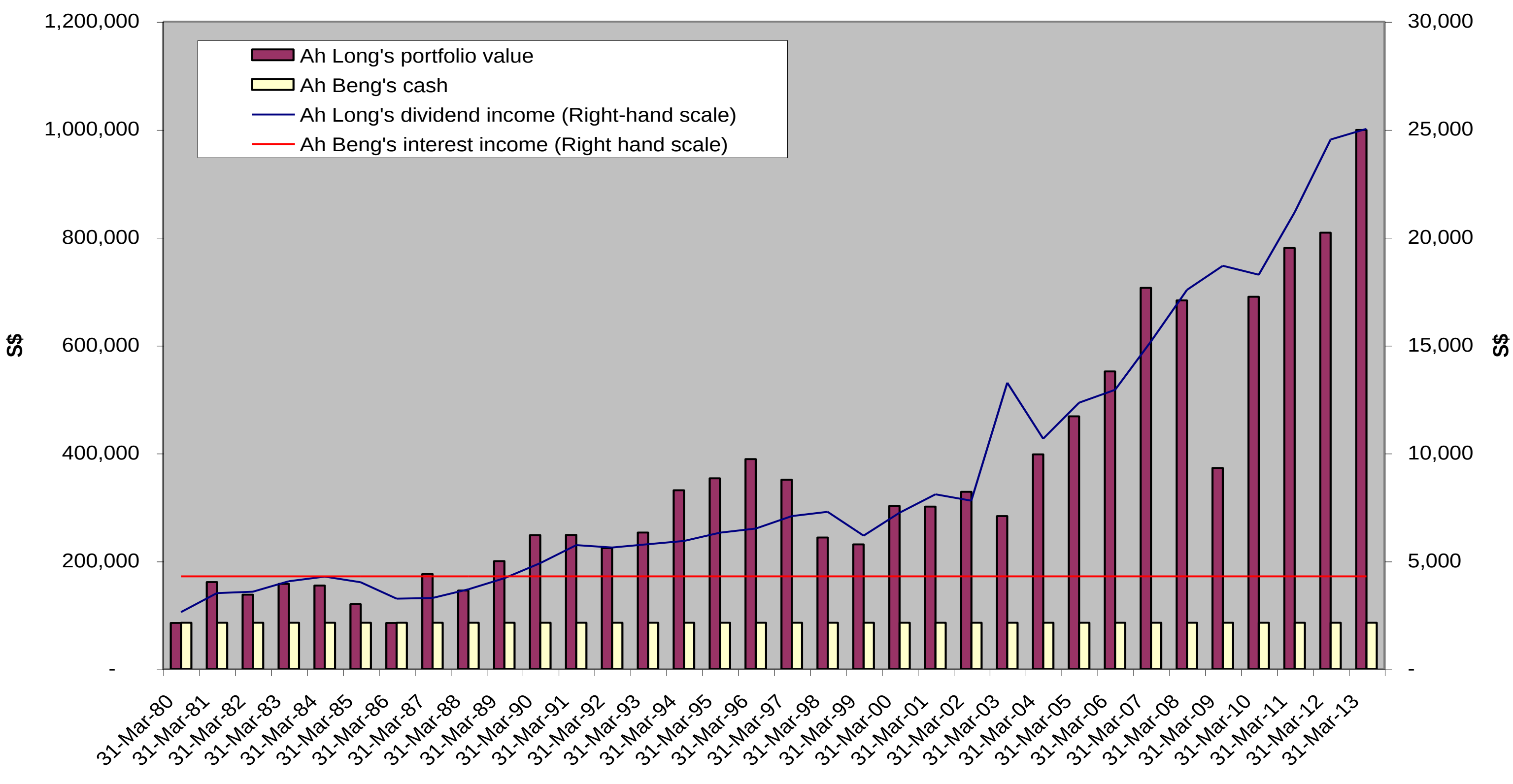
Beng's fixed deposit paid him 5 per cent a year, whereas Ah Long's portfolio only yielded about 3 per cent in dividends. But over time, the companies in Ah Long's portfolio grew and they were able to pay more dividends. By 1990, the dividends from the portfolio of stocks had exceeded the interest received from the fixed deposit. (See Chart 1)

Meanwhile, because the companies expanded, their market value also grew. By 1990, Ah Long's stock portfolio, which consisted of super performers like Jardine Cycle & Carriage and F&N, to underperformer like Auric Pacific, was worth $248,410. As for Ah Beng, the amount of cash he had in the bank remained at $86,000.

By end March 2013, Ah Long's portfolio had a market value of $999,334. The dividends he received for the preceding 12 months amounted to $25,030. Had Ah Long put his $86,000 in the Straits Times Index instead, his portfolio would be worth $637,000. With dividends reinvested, his portfolio is worth a whopping $1.3 million.

As for Ah Beng, his $86,000 fixed deposit is still in the bank. He is lucky because he locked in the 5 per cent interest rate, and so he is still receiving $4,300 from his fixed deposit. Had he not, he would get only 1 per cent or less from his fixed deposit today. That would mean $860 of interest a year!

Chart 1: Cash is safe, equities risky?

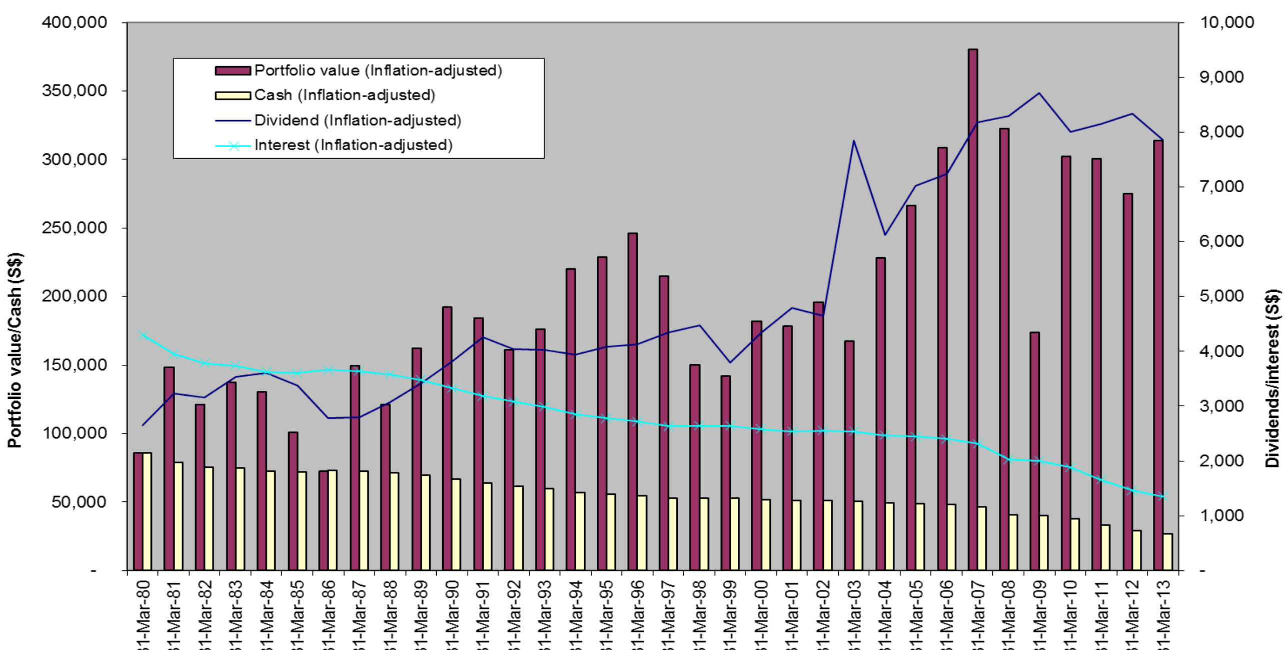


So Ah Beng had kept his money safe. But has he? The fact is, he has been losing purchasing power – to the tune of nearly 70 per cent in the past 33 years! (See Chart 2)

Because of inflation, which averaged about 2 per cent a year in Singapore in the past 33 years, his $86,000 today has a purchasing power equivalent to only $27,000 back in 1980. His $4,300 interest today is equivalent to $1,351 of the money back in 1980. Here's one clear example of how severe the loss of purchasing power can be. Back in 2003, $600,000 can get you a 750 sq ft freehold studio apartment in District 9. By 2013, $600,000 can barely get you any private apartment anywhere on the island.

Ah Long, after 33 years of being invested in equities, is in a better financial state. After adjusting for inflation, his portfolio is worth 3.7 times in terms of purchasing power relative to the $86,000 he had back in 1980. Had he reinvested all the dividends he received throughout the years back into the market, his portfolio would have been worth even more today. But of course, we all need to strike a balance between living today and in saving for the future.

Chart 2: Oops - cash is worth less than before!



So if we agree that investing is about delaying consumption today so that we can have the capacity to consume more at a later date, then the risk of investment is the probability of the loss of our purchasing power over the investment period. Given the data presented above, holding cash is indisputably more risky than holding equities!

Since we started with Warren Buffett, let's end with him as well. In October 2008, when the world was reeling from the global financial crisis, the Sage of Omaha told *The New York Times*: "Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."

Today, just under five years on, the Dow is close to 16,000 points. Shun equities at your own risk!

Hooi Ling on 13 May 2017: *The Dow Jones Industrial Index closed at 20,896.6 points yesterday!*