Who's Afraid of Equities?

By Teh Hooi Ling, CFA

Back during the dark days of the Asian Financial crisis, the sell-down in Straits Times Index and other regional bourses was relentless. Investors watched in horror as the value of their portfolios got smaller and smaller with each passing day. When the STI hit 800 points on 4 Sept 1998 – from 1,700 just six months ago, a panic-stricken remisier came up to his head of equities research and said: "Oh no! We only have 8 days to go before we hit zero!" The logic was that, if the STI continued to fall by 100 points a day, there would only be eight days left of the market.

It sounds funny now when the story is recounted. But at that time, that was a very real fear of investors and market participants alike. The numbers on the screens represented one's wealth. Every point of decline in the index would translate into a loss in the value of one's portfolio.

The thing is, when we are too absorbed in the violent market actions of the day, we lose sight of reality. If we were to step back and view the market with a cool head, we would realise that there was no way the stock market would hit zero.

Why?

One, the stock market represents real businesses with real assets. It represents the real economy. The stock you own gives you a stake in a company that makes money by selling a service or a product. Even if it is not profitable, it still owns assets like buildings and machinery which have a value and a price in the real market place.

If one can buy the shares of a listed company that owns a drinks bottling plant at half the price of building one, nobody will build a new plant. Those with money will just buy up the existing plants via the stock market.

This will drive up the stock prices of drinks factories. When the stock prices rise to such a level that it may be cheaper to build a new plant, a new set of entrepreneurs will come in to build new plants. This will mark the end of the "up" cycle in the stock prices of drinks factories.

Similarly, stock market prices can't go so high as to defy market realities. Say, you can install fibre-optic cables at just $1 but you can sell the completed network to investors in the stock market for a whopping $10. You can guarantee that many people would want to do that. This will result in overbuilding and prices for the use of fibre-optic cables will plunge. And when listed companies that own these networks can't make money, their stock prices will fall. This was exactly what happened in 2001 and 2002.

Two, the productive capacity of the economy (the company) comes from the skills and size of the workforce and the country's (company's) accumulated intellectual and physical capital.

"If GDP were to fall by 5 per cent, it would not be because our ability to produce goods and services had fallen by 5 per cent, but because aggregate demand for those goods and services had fallen. When the demand returns, the economy will be able to ramp up production quite quickly," said Ben Inker, asset management firm GMO's director of asset allocation wrote in a paper entitled "*Valuing Equities in Economic Crisis*".

The Great Depression caused the US GDP to fall by 25 per cent from 1929 to 1933. But that fall, as extraordinary as it was, was a fall in demand relative to potential GDP. It was not a fall in the economy's productive capacity. The economy eventually got back onto its previous growth trend as if the depression had never happened.

Equities are long duration assets, that is, they are valued based on the assumption that they will generate perpetual streams of income. So even if the economy is going to be horrible for the next five years and dividends are going to be cut by 50 per cent, the present value of the stock theoretically should only be reduced by 5 per cent! A 10-year slump would only wipe out 10 per cent of the stock's value. "To us, the true value of the stock market changes very slowly and smoothly**. It is the myopia of investors that causes market prices to vary so wildly**," he wrote.

Of course demand for a company's product or service may never come back after a slump if it can no longer produce things that the market wants, or at a price that the customers are willing to pay. Still, it would own assets like buildings and factories that another competitor may find value in.

There is one drastic scenario where demand would fall significantly and large swathes of industries would be affected – that would be a near complete destruction of the earth with more than half of the world's population being wiped out.

Barring the above scenario, humans' economic activities are unlikely to cease.

Risks

Yes, for individual companies, there will be instances when the value of their shares can fall to zero. That happens when a company has such high levels of debts that it owes more than all the assets it owns. Similarly for individual investors. They can be completely wiped out if they borrow substantially to invest, for example trade using margin accounts. When the market turns against them in the short term, they may not have excess capital to top up and will be forced to liquidate their stockholdings at depressed prices.

These two risks can be mitigated by opting to invest in companies with low debt levels, and by minimising our own debt exposure. Preferably, there should be zero debt used when it comes to equity investing.

Another element of risk relates to the price of the asset. The risk of an asset rises with its valuation. The higher the asset's price relative to its fair value, the higher its risks. Fair value is arrived at based on economic realities, some examples of which we talked about earlier. Price is what the market is willing to pay for the asset – it can be significantly higher or lower than the fair value.

Stocks at fair value are less risky than stocks trading 30 per cent above fair value. The expensive stocks have the risk of loss associated with them falling back to fair value. That "valuation" risk leads to losses that should not be expected to reverse anytime soon.

Meanwhile, a cheap stock can certainly go down in price, but when it does, one can expect either high compound returns from there, which makes one's money back steadily, or a reasonable sharp recovery when the conditions that drove prices down dissipate, which will make your money back quickly. The loss is therefore temporary, although it may seem unpleasant while it is occurring.

So the very first fundamental rule of investing is never overpay for an asset.

But even with cheap stocks, as mentioned earlier, the myopia of investors can cause stock prices to veer significantly from their fair value. Thus equities are known as "risk" assets.

GMO's Mr Inker puts it this way: "Equities cost you money at such an inconvenient time. The worst returns to equities come in recessions (bad), financial crises (very bad), depressions (very, very bad), and major wars (not good at all).

"While the average real return (after inflation) to the S&P 500 since 1900 was a reassuring 6.6 per cent a year, at those times when you were most at risk of losing your job, your bank account, your house or your life (during wars), you could rely on equities to be piling on the misery."

Therefore, it is only rational for equity holders to demand, and be rewarded with, a decent return for taking that very unfortunate return path. And it is rational for companies to be willing to pay it. For corporations, equity is the safest capital they can raise. Unlike debt, there are no mandated payments associated with it, and no need to periodically refinance it. If a company is looking to finance investments with long durations and significant potential volatility to the cash flows generated, equity is the financing choice that minimises the risk of the company going out of business.

“As a business owner, it is entirely rational to be willing to pay a higher expected rate of return to such ‘safe’ capital,” he noted.

So there you have it – the very fundamental reasons why equities should pay a higher return than cash and debts. Yes there are risks. But there are also ways to mitigate those risks.

If you buy the shares of a company that:

- has a good business;
- is backed by good assets;
- does not have a whole lot of borrowing;

and you:

- pay a decent price for the shares relative to its fair value;
- have the holding power to sit through any short term market volatility;
- invest in a basket of such stocks;
- do not over-leverage;

then you should not be afraid of equities!