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YIELD IS KEY TO LONG-TERM RETURNS

“The most realistic distinction between the investor and the speculator is found in their attitude towards stock-market movements. The speculator’s primary interest lies in anticipating and profiting from market fluctuations. The investor’s primary interest lies in acquiring and holding suitable securities at suitable prices.” Benjamin Graham

One of the crucial differences between investing and speculating is the time horizon. Investing is buying and holding a valuable asset with a realistic expectation of the long-term return; a speculator trades, and hopes to sell at a higher price. A speculator’s aspiration for returns is driven by price movements, generated by potentially selling on to a “greater fool”.

For instance, a speculator who bought bonds last month would have made a 3.5% return but, over a period of two weeks in September would have lost 3.2%, predominantly made up of price movement. However, an investor holding a bond to maturity will make all of their returns from yield. This thinking applies to equities too. As tabled below, the impact of reinvested dividends is significant, representing 25% of the total return on equities in the last 50 years. And if expressed relative to real returns, more than half. Very simply, the longer your investment time horizon, the more of your return will be made from yield and less from volatile price action

The last 50 years:	% p.a.
Total return on FTSE/JSE All Share Index (ALSI) incl dividends	17.7
Return on ALSI excluding dividends	12.5
Inflation	8.6
Real returns on ALSI	9.1
Impact of reinvesting dividends	5.2
Average dividend yield	4.4

Sources: OMIGSA and I-Net

Long-term returns

Our philosophy is to use a five-year investment time horizon when investing our clients’ money, which helps enormously to reduce the noise in markets. Long-time readers of Macro Solutions will be aware that we publish our expected five-year real return expectations (www.omigsa/msi).

For bonds, current yields are a good indication of what future nominal returns are going to be, although we do not know what inflation will be (refer table below). However, this month US 10-year inflation-linked bonds traded at -5 basis points (bps)! Although it was negative just on that day, this is a startling phenomenon as it shows investors are prepared to accept no real return (below inflation returns!) over 10 years, purely to protect their capital. At time of writing, 21 September, these bonds were trading at real yields of just 2bps.

	10-year bond yields 21/09/2011	July 2011 Inflation
US	1.9%	3.6%
Japan	1.0%	0.5%
Germany	1.8%	2.5%
UK	2.4%	4.5%
South Africa	8.5%	5.3%

Source: Inet

Cash is trash

The reason investors will accept flat returns is because they know they will actually go backwards in real terms if they remain in cash. This is due to the lethal combination of low interest rates and higher inflation. This is unlikely to change as developed economy central banks are taking increasingly desperate measures to ensure negative real interest rates.

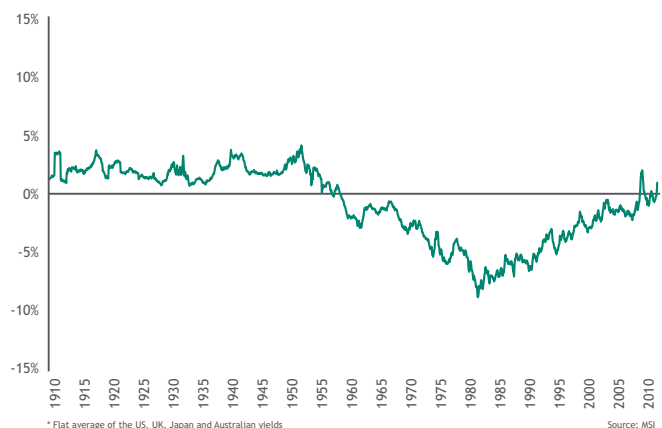
For instance, Ben Bernanke of the US Federal Reserve has committed to “exceptionally low levels for the federal funds rate, at least through mid-2013”. The Swiss National Bank “is prepared to buy foreign currency in unlimited quantities” to ensure the franc weakens against the euro.

The big picture

Once you remove cash and bonds, developed market investors are running out of investment options. Commodities (e.g. gold and silver) produce no yield and have already increased materially in real returns. This leaves equity and property as the best-yielding asset classes. This is an unusual situation, as shown by the 100-year graph below: *for the first time in more than 50 years dividend yields are greater than bond yields.*

We have used historic dividend yield, so a future collapse in earnings, and hence dividends, could reduce the attractiveness of equity. However, while not impossible it is not likely, as many companies in our investable universe are in excellent financial condition and are already retaining two-thirds of income, so we expect dividends will be safe. In fact, we expect additional returns on capital through special dividends, buy-backs and corporate action.

**Relative valuation:
Dividend yield minus bond yield***



This perspective gives us a high degree of conviction that equities will outperform bonds and cash over the next decade. The worst case scenario: growth is very soggy, markets move sideways and investors only receive their dividends. However, this will still be better than cash and bonds.

If inflation comes through strongly, equities will protect investors and bonds will underperform very badly. Therefore, whatever picture emerges, we favour equity in what we still expect will be a low return world.

How does this view reflect in your funds?

Within our funds we took advantage of the increased allowance to international assets. However, within this international allocation we have no exposure to offshore government bonds and are predominantly invested in equity. We also took a longer-term view and increased our equity exposure in the recent market turmoil.



For more information, visit www.omigsa.com/msi

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