What level of return should we accept from shares?

By Tim Farrelly, Principal – Farrelly's Investment Strategy

When we look at historical returns, we find that over very long periods of time, in a variety of countries, shares have generally produced returns of around 2 - 5% p.a. above cash – albeit with some variation and lots of volatility, as shown in Figure 1.

Figure 1: Historical returns of shares above cash

	15 years (2000-2015)	50 years (1965 - 2015)	115 years (1900-2015)
Australia	3.20%	3.60%	6.00%
World	2.00%	4.20%	4.20%
World Ex US	1.40%	4.60%	3.50%
US	2.70%	4.50%	5.60%
UK	0.90%	4.60%	4.40%

Source: Credit Suisse Global Investment Returns Yearbook 2016

So, at one level, we can say that cash + 5% p.a. is an excellent return from share investment over the long-term.

As an example, if you invested $100,000 for ten years in cash, it would grow to $122,000 – based on current cash rates of around 2% p.a.

However, $100,000 invested in shares returning 7% p.a. (i.e. 5% p.a. more than cash) would grow to almost $197,000 over 10 years.

That is a difference worth having.

Going ahead, how difficult will it be to achieve a return 5% p.a higher than cash?

It is useful to understand the past, but as legendary US investor Warren Buffett reminds us, "if returns came out of history books, librarians would all be millionaires".

In practice, share market returns come from income and growth and we find it very useful to separate the two to help us think about what future returns might be.

Currently, our research indicates that the top 300 Australian shares have an average dividend yield close to 5.5% p.a. – if we include imputation credits.

So, assuming average dividends remain at current levels, in order to beat cash by our historically derived target of 5% p.a. we need to obtain growth of just 1.5% p.a. This doesn't take much.

As shown in Figure 2, if buying at today's prices, then the market has to get to 6034 in 10 years time for us to earn our historical target of 5% above cash. That's just 16% above today's price, for us to be well on the way to receiving our target return, assuming average dividends do not change.

Figure 2: How far do share prices need to rise to give us growth of 1.5% p.a. (for shares purchased in June 2016 with an index value of 5200)

Target Date	All Ordinaries Index Indicative Target
Jun-17	5278
Jun-18	5357
Jun-19	5437
Jun-20	5519
Jun-21	5601
Jun-22	5686
Jun-23	5771
Jun-24	5857
Jun-25	5945
Jun-26	6034

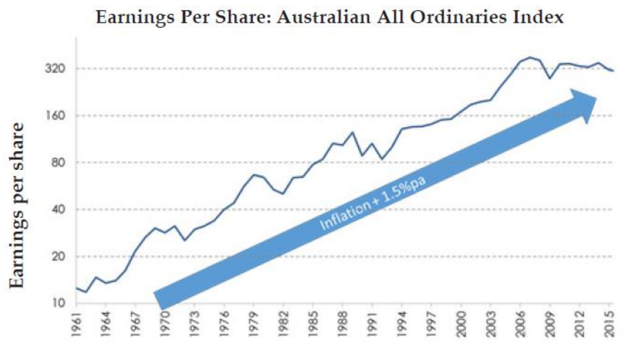
What is the likelihood of achieving 1.5% p.a. growth from shares?

The main source of share price growth in the very long term is growth in company profit as measured by earnings per share (EPS). As can be seen by Figure 3, the average growth rate for Australian shares has been inflation plus 1.5% p.a.

Going ahead, if inflation averages 2 to 2.5% p.a., we might expect earnings to grow at 3.5 to 4% p.a. If average earnings per share do continue to grow at 3.5 to 4.0% p.a., then such growth should be reflected in the share prices. That's well ahead of our target growth rate of share prices of 1.5% p.a.

It is important to note that past performance is not indicative of future returns and investors should consider whether the target investment horizon is appropriate for them, based on individual circumstances and needs.

Figure 3: Australian companies have grown EPS by 1.5% + CPI on average



Source: ASX, farrelly's analysis

Volatility and noise can hide the growth

While it seems easy to say that we just need 1.5% growth each year to meet a 'cash plus 5%' target, in practice it can be difficult to focus on the long term when we sometimes get that kind of gain – or loss – in a single day.

There will always be volatility because there is rarely a shortage of worries concerning investors in the share market, and those worries can translate into price falls. Today investors worry about the fallout from Brexit, a possible recession in Australia, Europe or the US, a slow-down in China, and rising US interest rates - the list goes on.

A similar list existed this time last year, and the year before, and almost every year before that. And yet, most of the time, the market churns out good returns when looked at over periods of five to ten years.

But not always. Occasionally we do experience long periods of poor returns from share market investments.

These periods of poor returns are usually not about falling earnings. In fact, our research indicates that over the past 55 years the biggest fall in earnings from the top 300 shares over a six year period was just 12%.

However, share prices are much more volatile. Over the same 55 years, we have seen seven periods where the average price of the top 300 shares has fallen by more than 12% over six year periods, with the largest six year fall being over 50% (according to our research). Clearly, something else is at work.

That something is the amount the market pays for each dollar of earnings.

When the market pays too much for earnings, long periods of poor performance inevitably follow. The market normally pays too much where there aren't enough things to worry about and investors get unduly optimistic.

It is ironic. In the share market, worries are generally a sign of good times ahead, while widespread optimism should make us nervous.

Which begs the question, how do we know if we are paying too much for earnings? The answer lies in the Tipping Point chart where we set out what we consider to be prices that are too high, fair, or cheap.

Where we are today?

The Tipping Point chart summarises how we see the markets today.

As you can see, most markets offer attractive returns over the next 10 years – in particular, quality Australian, European and Asian shares, and some emerging markets.

Figure 4: The Tipping Points

Australian Equities			Developed Market Equities			Emerging markets			Australian REITs		
All Ords Index	F'cast return	Status	S&P 500	F'cast return	Status	FTSE EM (Local)	F'cast return	Status	ASX REIT Index	F'cast return	Status
9750	1.4%	Overpriced	3600	2.6%	Overpriced	1000	1.3%	Overpriced	1750	3.0%	Overpriced
9250	2.1%	Overpriced	3400	3.3%	Fully priced	950	1.9%	Overpriced	1700	3.4%	Fully priced
8750	2.8%	Overpriced	3200	3.9%	Fully priced	900	2.5%	Overpriced	1650	3.8%	Fully priced
8250	3.6%	Fully priced	3100	4.3%	Fully priced	850	3.2%	Overpriced	1600	4.2%	Fully priced
7750	4.4%	Fully priced	3000	4.7%	Fully priced	800	3.9%	Fully priced	1550	4.7%	Fully priced
7250	5.3%	Fully priced	2900	5.1%	Fully priced	775	4.3%	Fully priced	1500	5.1%	Fully priced
7000	5.8%	Fair value	2800	5.5%	Fully priced	750	4.7%	Fully priced	1450	5.6%	Fully priced
6750	6.3%	Fair value	2700	5.9%	Fair value	725	5.1%	Fully priced	1425	5.9%	Fair value
6500	6.9%	Fair value	2600	6.4%	Fair value	700	5.5%	Fully priced	1400	6.1%	Fair value
6250	7.4%	Fair value	2500	6.8%	Fair value	675	6.0%	Fair value	1375	6.4%	Fair value
6000	8.0%	Fair value	2400	7.3%	Fair value	650	6.4%	Fair value	1350	6.7%	Fair value
5750	8.7%	Cheap	2300	7.8%	Fair value	625	6.9%	Fair value	1325	7.0%	Fair value
5500	9.4%	Cheap	2200	8.4%	Cheap	600	7.5%	Fair value	1300	7.2%	Fair value
5250	10.1%	Cheap	2100	9.0%	Cheap	575	8.0%	Fair value	1275	7.5%	Fair value
5000	10.8%	Cheap	2000	9.6%	Cheap	550	8.6%	Cheap	1250	7.8%	Fair value
4750	11.7%	Cheap	1900	10.3%	Cheap	525	9.2%	Cheap	1225	8.1%	Fair value
4500	12.6%	Cheap	1800	11.0%	Cheap	500	9.9%	Cheap	1200	8.5%	Cheap

Data as at June 2016. Source: Farrelly's Asset Allocation. No guarantee is implied as to the accuracy of the specific forecasts provided.
ROW = Rest of the world. US = United States of America.

By the way, in this chart, if share markets are expected to return more than 5% above term deposits or cash they are shown as green. Today we can see that we expect Australian equities to return close to 10% p.a. over the next decade, made up of 5.5% dividends plus 4.5% earnings growth, which is a lot better than our fair value target of 1.5% earnings growth. Essentially, we see Australian shares as cheap today.

In the blue zones, markets are fair value – here we expect to get the 2.5% to 5% above term deposits, around the historical averages and safely above the no risk alternative.

When we get to the yellow zone it is time for caution. We are expected to get better returns than term deposits, but with not much of a margin of safety. And in the red zones, investments are expected to return less than term deposits – it is time to be moving to the exits.

Our recommended investment strategy

Our investment strategy is straightforward. Invest, ignore the noise, ignore the volatility, ignore the pessimists and enjoy solid returns over the long term. But stay vigilant. The time will come again where the markets will not appear nearly so attractive as they currently are.