J. STERN & CO.

The Value of Long-Term Investing

Investment Insight

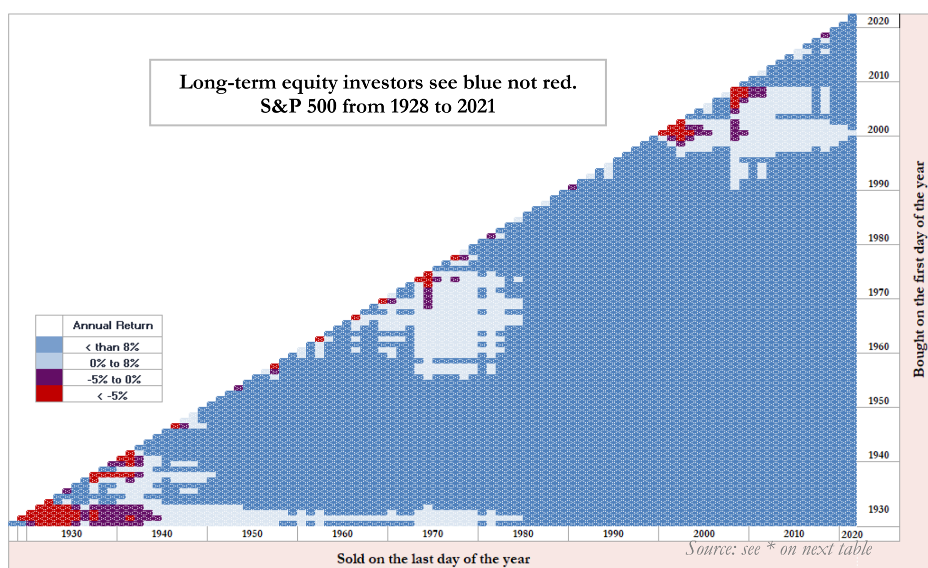
THE RETURN TRIANGLE: WHY IT PAYS TO HOLD EQUITIES THROUGH UNCERTAIN AND CHALLENGING MARKETS

On many occasions in the last c.100 years, leading stock markets have suffered significant pullbacks for various reasons be they technical, economic or fundamental, but almost invariably equity markets have recovered their poise within a time-frame of five years, and often much less. Analysis shows that long-term investors who remain calm, do not attempt to 'time' markets and stay invested will often be rewarded with high-single-digit compound annual returns.

Understandably, investors are currently nervous given the range of uncertainties from the Ukraine crisis and its aftermath to rising inflation. According to a recent *Reuters* poll, investors are cautious. Many global fund managers and large endowments have been reducing their exposure to equities in favour of sovereign bonds and cash. It's a strategy that we find ourselves at odds with, and we said as much in the article that accompanied the poll's result. In an inflationary environment, equities are the only large, liquid and accessible asset class which can generate significant real returns. The market correction means that many high-quality, large companies are at very attractive prices, down 20% or more in some cases. That is why any weakness is as much an opportunity for us, as for any long-term investors.

We prefer to take a step back and focus on the long term and company-specific fundamentals. There is also another powerful reason why investors should not let short-term noise interfere with their investment strategy. History tells us that equities generate meaningful compound returns if you remain patient and invest for long periods. This phenomenon is illustrated by the Return Triangle from Deutsches Aktieninstiut. It neatly demonstrates that no matter how bad a crisis gets, equity investors that stay the course will reap the rewards over time.

The Aktieninstiut's original model is based on the DAX, the German stock market index, but we have adopted its model to show the compounded returns of the S&P 500 since 1928, an index that is more relevant for global investors such as ourselves. In simple terms, the colours in the chart change depending on the annualised return. The blue blocks in the chart represent years when share prices have risen and the purple and red blocks depict when they have fallen.



It is striking that blue blocks overwhelmingly dominate the chart, highlighting that share prices go up more often than not.

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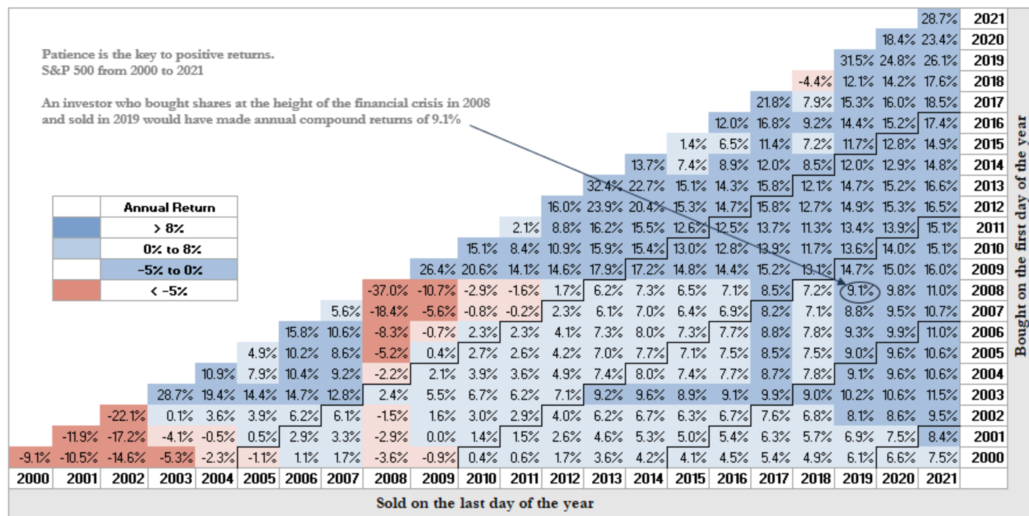
Equally significant is that the chart highlights that when shares suffer 'red' years, it doesn't take many years for investments to recover and turn blue because of the powerful effect of compound returns.

Our chart goes back to 1928 and in the 94 years since 1928, the S&P 500 has fallen 25 times (as depicted by the purple and red blocks on the outer edge). Notably, light blue and dark blue blocks, which represent positive returns (positive returns up to 8% and returns in excess of 8% respectively) dominate. This is important as it shows that the longer you hold onto your investment the more likely poor performing years will be offset by the good years generating positive compound annual returns.

How the Return Triangle works

The triangle summarises total returns in USD of the S&P 500 index over 2000-21. It combines annual returns in each discrete year with computations of compound returns over multiple time periods. Each column of boxes in the triangle represents a year. The Y-axis logs the year of purchase (in January) and the X-axis the year of sale (always December). For example, in the excerpt below, go to the upper right corner of the X-axis and you'll see the number 28.7. This shows that the S&P 500 rose by 28.7% in 2021. Now, if you descend the ladder from the top edge, you will see that in 2020, the index's return was 18.4% and in 2019 it was 31.5%. In 2018, the S&P 500 fell by 4.4%, but keep descending and it is not until 2008 before the index falls again.



Bought \ Sold	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
2021																						28.7%
2020																					18.4%	23.4%
2019																				31.5%	24.8%	26.1%
2018																			-4.4%	12.1%	14.2%	17.6%
2017																		21.8%	7.9%	15.3%	16.0%	18.5%
2016																	12.0%	16.8%	9.2%	14.4%	15.2%	17.4%
2015																1.4%	6.5%	11.4%	7.2%	11.7%	12.8%	14.9%
2014															13.7%	7.4%	8.9%	12.0%	8.5%	12.0%	12.9%	14.8%
2013														32.4%	22.7%	15.1%	14.3%	15.8%	12.1%	14.7%	15.2%	16.6%
2012													16.0%	23.9%	20.4%	15.3%	14.7%	15.8%	12.7%	14.9%	15.3%	16.5%
2011												2.1%	8.8%	16.2%	15.5%	12.6%	12.5%	13.7%	11.3%	13.4%	13.9%	15.1%
2010											15.1%	8.4%	10.9%	15.9%	15.4%	13.0%	12.8%	13.9%	11.7%	13.6%	14.0%	15.1%
2009										26.4%	20.6%	14.1%	14.6%	17.9%	17.2%	14.8%	14.4%	15.2%	13.1%	14.7%	15.0%	16.0%
2008									-37.0%	-10.7%	-2.9%	-1.6%	1.7%	6.2%	7.3%	6.5%	7.1%	8.5%	7.2%	9.1%	9.8%	11.0%
2007								5.6%	-18.4%	-5.6%	-0.8%	-0.2%	2.3%	6.1%	7.0%	6.4%	6.9%	8.2%	7.1%	8.8%	9.5%	10.7%
2006							15.8%	10.6%	-8.3%	-0.7%	2.3%	2.3%	4.1%	7.3%	8.0%	7.3%	7.7%	8.8%	7.8%	9.3%	9.9%	11.0%
2005						4.9%	10.2%	8.6%	-5.2%	0.4%	2.7%	2.6%	4.2%	7.0%	7.7%	7.1%	7.5%	8.5%	7.5%	9.0%	9.6%	10.6%
2004					10.9%	7.9%	10.4%	9.2%	-2.2%	2.1%	3.9%	3.6%	4.9%	7.4%	8.0%	7.4%	7.7%	8.7%	7.8%	9.1%	9.6%	10.6%
2003				28.7%	19.4%	14.4%	14.7%	12.8%	2.4%	5.5%	6.7%	6.2%	7.1%	9.2%	9.6%	8.9%	9.1%	9.9%	9.0%	10.2%	10.6%	11.5%
2002			-22.1%	0.1%	3.6%	3.9%	6.2%	6.1%	-1.5%	1.6%	3.0%	2.9%	4.0%	6.2%	6.7%	6.3%	6.7%	7.6%	6.8%	8.1%	8.6%	9.5%
2001		-11.9%	-17.2%	-4.1%	-0.5%	0.5%	2.9%	3.3%	-2.9%	0.0%	1.4%	1.5%	2.6%	4.6%	5.3%	5.0%	5.4%	6.3%	5.7%	6.9%	7.5%	8.4%
2000	-9.1%	-10.5%	-14.6%	-5.3%	-2.3%	-1.1%	1.1%	1.7%	-3.6%	-0.9%	0.4%	0.6%	1.7%	3.6%	4.2%	4.1%	4.5%	5.4%	4.9%	6.1%	6.6%	7.5%

**This chart shows the annual percentage return for S&P 500 from its creation until the end of 2021, with dividends reinvested, in USD. No taxes, costs, charges or expenses are taken into account. Source: Deutsches Aktieninsitut.*

The return triangle emphasizes the power of positive years following 'down years' and the frequency of positive compound annual returns. Let's start with one of the worst periods of stock market performance in recent history. When the dotcom bubble burst in early 2000 share prices fell sharply and the triangle reveals it would have taken an investor who invested in the Millennium seven years to recover their losses.

The bottom box at the far left of the X-axis shows that if you bought the stocks at the beginning of 2000 and sold them at the end of the year, you would have made a loss of 9.1%. If you had bought shares in 2000 but sold them a year later, your loss would have widened by

10.5%. Keep moving along the columns at the bottom of the X-axis and you can see that those losses widened further in 2002 (14.6%) as the fallout continued.

From 2003 to 2005 share prices began to rise and your compound returns, while still negative, were lower than in 2000. You don't come across a blue block again until the 2006 column. This shows that an investor who bought in January 2000 and held onto their shares until December 2006, throughout the dotcom fallout and subsequent recovery, would have generated a compound annual rate of return of 1.1%.

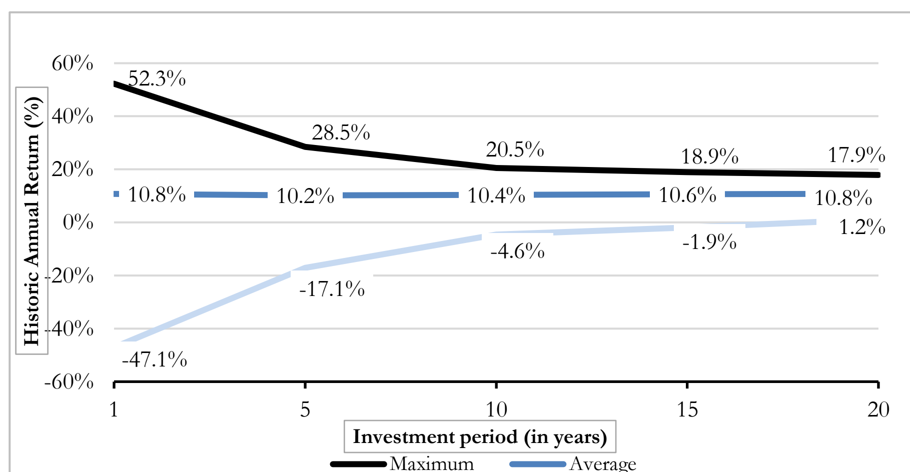
Seven years is a relatively long holding period for some investors, but the dotcom bubble was a crisis on a par with the 1929 Wall Street crash and the 1973 oil crisis. That aside, over the best part of a century, investors have typically only had to wait one or two years after a bad stock market year before their investments started to recover significantly. The triangle shows that even an investor who bought in January 2008, before the global financial crisis, would have recouped their losses within five years, with a total return of 1.7% CAGR in December 2012.

Patience is rewarded time after time

Deutsches Aktieninstiut's Return Triangle demonstrates that patience is rewarded. An investor who invested in the S&P 500 in January 2008 and was still holding onto their investments in December 2021 would have made an 11% compound annual return in USD. Indeed, the lowest compound annual return since the Millennium for any period is 7.5% (over the longest period of 2000-21), and investors would have been rewarded with double-digit returns in 13 of those 22 discrete years.

The S&P 500 index has admittedly been one of the best performing global equity indices over most time periods, but the returns over longer time periods are consistently strong and particularly in recent times. For example, a 20-year investment in the S&P 500 to a sale date in December 2021 would have yielded compound annual returns of 9.5%, over 10 years 16.5% and five years 18.5%. And we can go back further. An investor who invested $1,000 in 1928 would be sitting on more than $3 million today having generated compound returns of 9.7%, including reinvested dividends and before costs.

The line chart below shows the range of returns in the S&P 500 over 1/5/10/15/20-year periods since 1928, summarised from the chart on page one. Over a 20-year investment period the average compound annual return has been 10.8%. Interestingly the average compound return of all five, ten and fifteen year periods has been in the range of 10.2-10.6%. For twenty-



year periods only, the compound return has ranged from 1.2-17.9%.

Throughout the past 94 years, it is difficult to find periods where an investor would have made less than 8% compound from buying and holding US stocks, even if they had bought them right before a major correction.

This tells us that even if we are facing headwinds, and even if we suffer a couple of years of volatile stock market performance that if your holding period is five years or longer, then the chances that you won't make positive returns are very low. On the contrary, the chances are high that you will make 8% or more compound returns over the long term, which is exactly what equity investors are looking for.

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