Will shares produce the highest returns long-term?

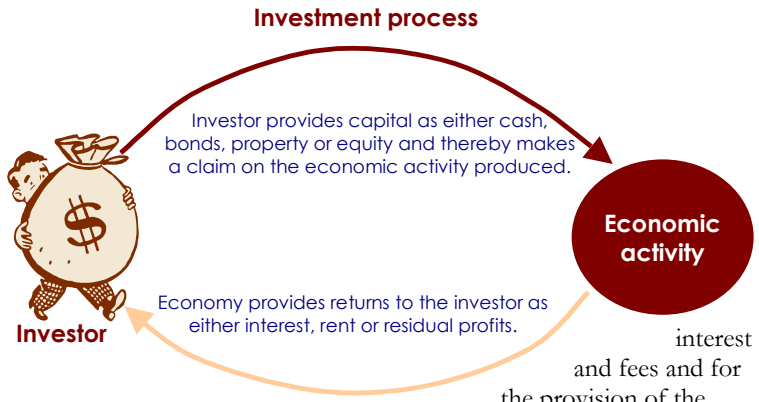
When it comes to investing, where should you get the highest returns on your capital? If we are talking long-term and are focussing on the main asset classes, the answer is probably from shares.

Historically, shares have produced the highest returns and it is generally accepted that this will continue to be the case. Intuitively, it makes sense. Shareholders take the greatest risk of capital loss and are the last in line to be paid a return. They should, therefore, ultimately get the highest return. The market forces within the economy as a whole should ensure that this remains true over the long-term.

Investment process

In simple terms, when investors invest their capital, they are looking to get back their capital and to receive a return on that capital in the meantime. The return comes from the economic activity generated by the user of the capital. Therefore, by investing an investor is making a claim for a share of the overall income produced by the economy. That claim, in terms of the level and the certainty of receiving it, will reflect how they make the investment. The investment may be by way of short-term loans (i.e. cash), long-term loans (i.e. bonds), the provision of property (e.g. an office) or as equity. Each way makes a particular type of claim on the economic activity and therefore has its own expected return and is exposed to different types of risks. The returns to the providers of cash, bond investors and property investors are normally fixed. Equity investors (i.e. shareholders) get what is left.

Graphically, the investment process is



The level of the economic activity generated governs the returns provided to investors.

Economic activity

Organisations need capital to fund the running of their businesses and to develop through expansion and research. The revenue they receive by their activities, in turn provides the returns to the providers of the capital, after meeting the costs of the raw materials, services and labour inputs.

The money flows can be translated into a simplified model (refer diagram next page). Dollars❶(i.e. income or revenue) flow into an organisation as a result of the organisation's activities. These dollars get allocated to:

Other organisations❷, for payment of the inputs and services, that they provide to the main organisation.

Employees❸ as wages, salary and bonuses for the provision of their labour.

Banks❹, by way of payment of interest and fees and for the provision of the short term capital needed by the organisation.

Bond holders and finance companies❺, for the provision of the longer term fixed interest capital.

Property owners❻, as rent for use of buildings and equipment

The IRD❼ as tax, with the residual going to the shareholders❽.

Payments to shareholders may be by way of dividends or by way of growth in share price through retained profits.

We can debate the order of the allocation of the organisation's revenue but the end result is the same. Shareholders provide risk capital and receive the residual profits. This is after banks have received interest, bond holders their interest and landlords their rent. Should, over time, the interest paid to banks be higher than the returns gained by shareholders? No; for the markets to work as a whole, the shareholder has to receive more long-term, but not in every year as then no one would invest through the cash market.

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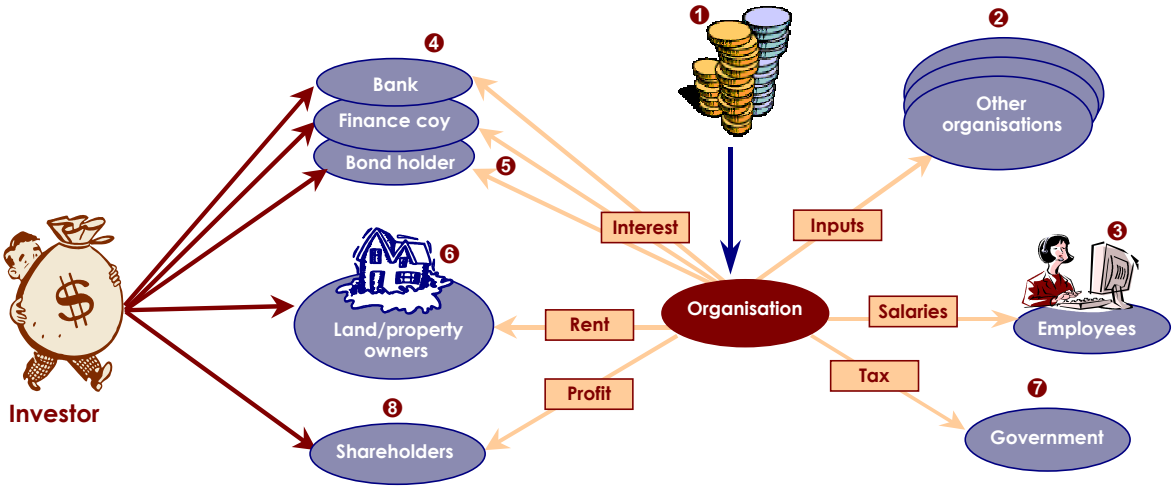
Model of economic activity



In mathematical terms, the return to shareholders is the value over time of:

Shareholder return❽

- = revenue of company❶
- - raw material and other input costs❷
- - wages❸
- - interest costs❹ , ❺
- - rent❻
- - tax❼

Over time the market self-corrects

The economic model of how the investment process works, and therefore how the economy works, is reasonably straightforward. However, its operation is complex because of the interconnections and uncertainty. It will however, always "try" to be in "balance".

From time to time, the allocation of economic activity will get out of balance; interest rates will rise too high, or wages will go up too fast. In each case, the immediate result is lower residual profits. But that can only happen for a short period of time before the shareholders conclude that they are disadvantaged and look to withdraw their capital or, more importantly, not put in new capital. If a company is to grow it needs new capital. Shareholders have to receive appropriate returns on the capital they have invested to encourage them to invest more. Economic forces will therefore look to bring the model back into balance.

If employees (or executives) receive more than an appropriate share then, unless that additional amount is funded by way of real growth (increased overall income net of any additional costs), the shareholders must get less. This will normally be tolerated by the shareholders for only a limited time.

If shareholders (the last in line) and those that take on more return uncertainty (i.e. investment risk), do not receive the greater share of the rewards overall, then on average, they will choose to provide money to organisations by way of loans (as cash or bonds) or to buy property and machinery, and rent it to the organisation. Logic dictates that investors that take on risk (i.e. uncertainty of return) will put up with poor returns for only a limited period, before taking action. Economic forces will therefore, overtime aim to, ensure that shareholders are appropriately rewarded.

Historical returns

Historically, shareholders have received a premium over other providers of capital, but not in every year. Using the last 25 years as an example, the relevant comparison of returns, after-tax, at 33%, is set out in table 1.

Of course in the context of the long-term, 25 years is relatively short and must be put in the context of the regulatory controls present prior to the NZ dollar floating and the Trustee Act being amended in 1988.

Table 1

Sector	Return	Premium relative to cash	Frequency[1] that annual return was greater than cash
	% p.a.	% p.a.	
Cash	7.7	-	-
NZ bonds	8.1	0.4	57%
OS bonds hedged	7.9	0.2	61%
Property	6.9	-0.8	66%
NZ shares	12.8	4.9	65%
OS shares unhedged	12.7	5.0	61%
OS shares hedged	9.9	2.2	61%

1. *A frequency, for example, of 57% for NZ bonds means that, in any given year, NZ bonds outperformed cash 57% of the time and cash outperformed bonds 43% of the time.*

Source: MCA NZ Limited, based on market index returns to 1 January 2004 after tax at 33%

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