



Brent Sheather's RESEARCH

Private Asset Management Ltd

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Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

TRUST OBJECTIVES: REALISTIC OR NOT? – Part 1

Back in November 2023 we looked at the Mulligan case - "Trustee lessons from the Mulligan case". That story highlighted the fact that, in the period 1965 – 1990, for a fixed-interest portfolio where all the income was spent, the capital value dramatically underperformed inflation. This was a particularly bad time for nominal assets like conventional bonds with prices in NZ rising more than 10-fold from the beginning of 1965 to the end of 1990 so no wonder the residual beneficiaries were unhappy. This case got me thinking as to whether the typical dual objectives of a family or charitable trust of producing a high level of income (to be spent by the beneficiaries) and at the same time maintaining the real value of the assets was achievable and realistic. Many of my clients are retired and most tend to happily spend all of the post tax, post fee income their investment portfolio produces but are much less enthusiastic about spending the capital. I suspect that this behaviour is based on the assumption that this strategy will preserve the real value of their savings for their children and grandchildren, charities etc. But is this a reasonable expectation?

To investigate this issue we assembled data on the capital only and total returns for NZ and US bonds and equities for the period 1925 – 2023, together with the inflation numbers for that period also. I don't have data for international bonds and equities so have used US data as a proxy for these asset classes. This will overstate returns because US equities and bonds have

done so well relative to the rest of the world. Note however that US equities now account for about 2/3 rds of the worlds' stock market.

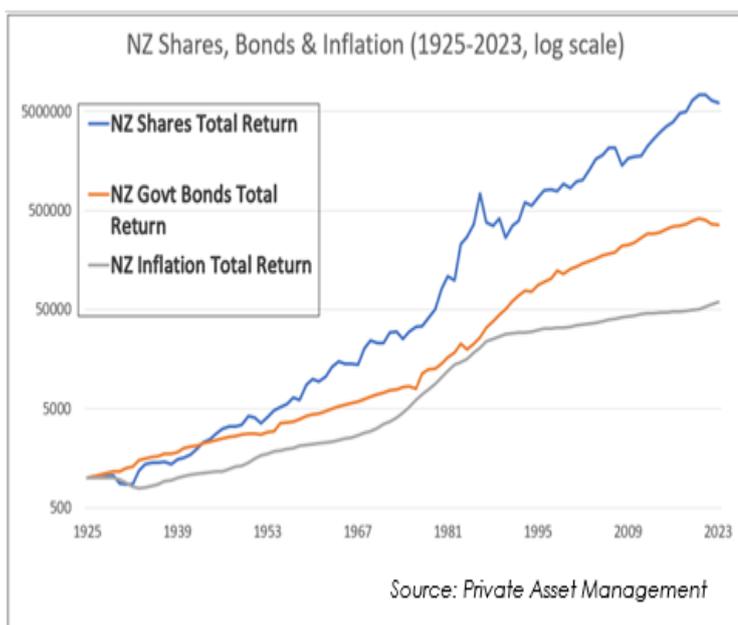
In this two part story we will first look at the long term data (because this sort of stuff is really interesting!) then try to draw some conclusions as regards current interest rates and share market returns. In part two we will test the robustness of these competing dual objectives for different asset allocations, conveniently ignoring fees and tax as these cost factors are generally funded from income.

First off though let's get some perspective on historic returns and inflation. Over that 1925 – 2023 period the performance of global equities, particularly those in the US, have benefitted from that asset class becoming more expensive in terms of price-earnings ratio and a higher (than today) dividend yield. The first variable may or may not be sustainable but only an optimist would assume that shares will continue to get more expensive. Therefore historic performance is likely to be considerably better than prospective returns. Over those 99 years, US stocks have averaged a compound return of 10% pa, further enhanced for many overseas investors by a stronger US currency. This impressive rate of growth turned US\$1,000 invested in 1925 into just over \$13m (unadjusted for inflation) by the end of 2023. Accordingly, with the benefit of the increasing valuation tailwind and the fact that, unlike Europe, Japan amongst others, World Wars I and II were mostly fought

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overseas, US shares have been one of the world's best performers, perhaps prompting the authors of the preeminent authority on long term global returns, the Global Investment Returns Yearbook (GIRY), to describe this period for share investors as "The Triumph of the Optimists". The 2023 GIRY notes that the higher return of US stocks was due chiefly to the relatively high growth in dividends and US stocks becoming more expensive over time. Looking at the numbers US companies grew their dividends, in real terms, at an average of 1.6% pa placing the US market as the second most successful based on this metric. Not so good news, depending on your perspective, is that US shares, reflecting their success have become more expensive over the long term with the price to dividend ratio growing by an average of 0.66% pa. This doesn't mean US stocks are necessarily expensive today - just that they are more expensive than they were; perhaps reflecting America's dominance in the tech sector and the fact that investment in stocks today, with the advent of funds like ETFs, makes it less risky.

NZ shares over the same period returned 9.3% pa – well ahead of inflation at 4.2% pa and government bonds at 6.1% pa. Recall that the return on shares is equal to the dividend yield



(dividend/shareprice) plus growth in earnings per share plus/minus any change in valuation.

The Global Investment Returns Yearbook (GIRY) tells us that for the NZ stock market the average dividend yield, 1900 – 2022, was 5.2% and dividends have grown over that period at a real rate of 1.2% pa. But, unlike most other countries, NZ shares have actually become less expensive over the period thereby reducing real returns by 0.4% pa to give a total real return (after inflation) of about 6.1% pa. Returns from shares, particularly those in small countries like NZ, can be volatile: the GIRY notes that the best year was 1983 when NZ equities returned 119% and the worst was 1987 when investors suffered a 49% loss. In the much larger US stock market one has to go way back to 1931 to find the worst year when stocks fell by 44.3%. Note that these returns are not in common currency and the GIRY reports that since 1900 the \$NZD has fallen by an average of 1.0% per annum against the \$USD due to higher inflation locally.

The NZ 10 year government bond yield has averaged about 5.9% per annum over the period hitting a high of almost 19% in March of 1986 and a low of less than 1% in 2020. Inflation has averaged 4.2% so the 10 year yield has been priced, on average, around 1.7% higher than inflation. Today the 10-year yields about 4.6% and inflation in the last 12 months ended December 31st was 4.7%. But the price of 10 year bonds are forward looking, ie they are priced having regard to future inflation rates not historic so maybe a better comparison would be to compare the current 10 year yield with forecast inflation. Buyers of 10 year NZ Government obviously are interested in inflation over the next 10 years and a hint as to what this number could be is provided by Treasury which estimates that inflation will average 2.6% pa in the next five years which implies a margin of 2.0% - much closer to the historic average of 1.7%.

In two weeks time we will look at the question as to whether a retired individual with a balanced portfolio, spending all the income, can reasonably expect that the real value of their portfolio will be maintained.

[Brent Sheather's A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.](#)