

Investment basics — I

THE REVERSE YIELD GAP AND REAL RETURN

Until the 1960's it was generally the case, both in South Africa and elsewhere, that returns on equities were **higher** than on fixed interest securities. The yield gap between the two was taken for granted and was supposed, largely, to reflect the riskiness of ordinary shares. Indeed, trustee portfolios seldom included any equities at all. The greater riskiness of equities was due, inter alia, to the following:

- A more cyclical business environment (and a closer proximity in time to the depression years of the 1930's), leading to greater fluctuations in earnings and dividends.
- The poor quality and quantity of information published

by companies: prior to 1952, for instance, it was not necessary to present consolidated accounts.

- The absence of modern management techniques: proper costing and budgetary systems were, for example, lacking.

In such an environment the assets of the trust or pension fund were largely deployed into high quality, fixed interest stocks of government and semi-official institutions where capital and income were highly secure and where **real** returns over time could confidently be anticipated. Rates of interest were remarkably low by today's standards, but so were rates of inflation.

In South Africa, this happy state of affairs (low interest rates, low inflation) prevailed until the end of the 1960's.

% per annum

Year	Long-term gilt rate	Inflation	'Real' rate	Year	Long-term gilt rate	Inflation	'Real' rate
1950	3,6	4,0	-0,4	1960	5,4	1,4	+4,0
1951	3,6	7,4*	-3,8	1961	5,9	1,9	+4,0
1952	4,3	8,7*	-4,4	1962	4,8	1,5	+3,3
1953	4,5	3,5	+1,0	1963	4,8	1,2	+3,6
1954	4,3	1,8	+2,5	1964	5,0	2,4	+2,4
1955	4,8	3,1	+1,7	1965	6,0	4,0	+2,0
1956	4,8	1,9	+2,9	1966	6,5	3,7	+2,8
1957	4,8	3,0	+1,8	1967	6,5	3,4	+3,1
1958	5,3	3,4	+1,9	1968	6,5	2,0	+4,5
1959	5,3	1,2	+4,1	1969	6,5	3,3	+3,2

*Korean War inflation

Average real rate 1953 to 1969: 2,9%

The 1970's have seen sharply higher nominal rates of interest but a greater acceleration in rates of inflation, and long-term government stock income returns became negative in real terms after 1972.

% per annum

Year	Gilts	Inflation	Real return
1970	7,8	4,1	+3,7
1971	8,5	5,7	+2,8
1972	8,1	6,5	+1,6
1973	8,0	9,6	-1,6
1974	8,9	11,6	-2,7
1975	9,7	13,5	-3,8
1976	10,4	11,1	-0,7

Long-term holders (those who did not trade their fixed interest portfolios) of long-term gilts also found their capital values eroding as new issues were floated at successively higher rates. For example, as rates moved up from 8% to 10%, capital values fell from 100 to 80 —

a decline of 20%. In recent years, funds have thus seen not only income returns that are negative in real terms but continuing (if normally unrealised) capital losses as well — a most unsatisfactory situation.

But to return to earlier years and the yield gap between equities and fixed interest. Memories of the 1930's were inevitably becoming dimmer, while at the same time the fundamental 'riskiness' of equity investment was diminishing as accounting and disclosure standards improved, stock exchange practices were tightened and general business cycles became less pronounced. The adoption by the authorities of the Economic Development Programme and the new focus on planned economic growth also drew attention to the long-term potential of equity investment.

Essentially, local investors, following their overseas colleagues, began to be aware that economic growth over time was likely to be associated (given the continued existence of a private sector) with profit and therefore **dividend growth**. If dividends were to **grow** and fixed interest was to remain fixed interest, the income return from equities would over time increasingly outstrip that from fixed interest. But investors would

not allow market value yields to rise beyond a certain point if they had any confidence in the future stream of dividends from the company. They would always value the equity at a yield in the market they considered

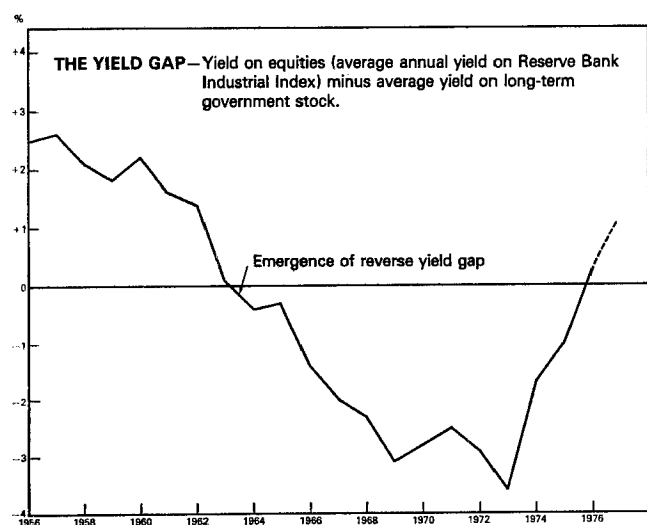
acceptable, so that any dividend **growth** would be reflected in upward movement in the share price: dividend growth, given a constant acceptable yield, would generate equivalent capital growth.

	Fixed interest			Equity	
	Year 1	Year 2		Year 1	Year 2
Income yield	6,0%	6,0%	Income yield	6,0% say	6,0%
Interest	6,0c	6,0c	Dividend	6,0c	6,6c say
Price	100c	100c	Price	100c	110c
Capital gain	—	nil	Capital gain	—	10,0%
Total return	6,0%	6,0%	Total return	6,0%	16,0%

The 10% increase in the dividend has translated itself (given the same market yield of 6% in Year 2) into a 10% capital gain and has generated a **total return of 16%**, substantially better than the return on the fixed interest security. In South Africa the equity had and still has a further attraction to many classes of investor arising from the favourable treatment for tax purposes of dividend income.

It soon, of course, became clear that given any sort of time horizon at all it was worth accepting a somewhat **lower** yield on the equity than on the fixed interest security. Growth in dividends would at some stage take the annual income from the equity up to and past the income from the fixed interest security and this took no account of capital growth! Thus, not surprisingly, the so-called cult of the equity developed and the reverse yield gap emerged. Particularly in other countries, its later stages in the 1960's were associated with the beginnings of an upward shift in inflation. This led to rising interest rates (and capital losses on gilts) and, for a time, enhanced company profit growth. Equities were thus seen as an inflation hedge and their superior merits appeared even more obvious.

In South Africa the reverse yield gap emerged first in the early 1960's as our chart shows:



Almost the precise shift in acceptable yield shown above has, in fact, occurred since the beginning of the decade: in 1971 the average industrial yield (Reserve Bank index) was 6,0%. In April 1977 it stood at 12,1%.

But in the process a most interesting development has recently taken place: the reverse yield gap has disappeared. Following an annual average positive gap of 0,3% in 1976, the April 1977 gap was a positive 1,1% — the largest since 1962. Equities on this basis offer better value than for many years.

The gap continued until recently, reaching its greatest extent (on an annual average basis) in 1973. However, the period since 1970 has not, as most of us know, been associated with buoyant equity markets. This is despite very acceptable profit growth over the period. What has gone wrong?

The one word answer (perversely) is **inflation** which pushed up interest rates and thus the average acceptable equity yield, eroded the quality of corporate earnings and increased the average cover. While mild (1% to 5%) inflation might well have been 'good' for equities, 10% plus rates were clearly destructive in their influence.

	Equity	
	Year 1	Year 2
Income yield	6,0%	12,0%*
Dividend	6,0c	10,0c say
Price	100c	83c
Capital loss	—	17%
Total return	6,0%	-5%

*Via higher acceptable yield.