Business Standard

# Global investment return conundrum

**It is surprising to see equities underperform bonds for 19 years, of which the last 10 have been an equity bull run**

**Akash Prakash March 12, 2019** Last Updated at 01:06 IST

I had the opportunity to read the latest *CS Global Investment Returns Yearbook 2019*, produced by the Credit Suisse Research Institute. As always, it was a fascinating read, full of data and insight. This year's issue had some additional data on the Emerging Markets (EM) and was therefore even more relevant.

On EM, the report looked at data from 1980 onwards and made some interesting observations. Firstly, when looking at the current construct of the MSCI EM index, you realise that out of 24 countries in the index, only six matter. The combined weights of China, Korea,Taiwan, India, Brazil and South Africa are nearly 80 per cent. Asia by itself has almost a 75 per cent weightage in the index, making all the other regions almost inconsequential. China at an index weight of almost 33 per cent (will soon rise to over 35 per cent in 2019 with greater inclusion of the A shares) also dominates the index. What you realise also is how much the EM investing world has changed over the last 30 years. At its inception in 1988, the MSCI EM index had Malaysia as its largest constituent, with a weightage of over 33 per cent. The next biggest markets were Brazil with a weightage of 19 per cent, followed by Thailand and Chile at 9 per cent. Except Brazil, all these markets are irrelevant today. There was no India or China in the index. China entered the EM index only in 1996, with a weightage of less than 0.5 per cent. How much things have changed! In terms of long-term performance, since inception in 1988, the EM index has delivered a gross return in USD of 10.67 per cent annualised compared to 7.8 per cent for the MSCI World index. Versus the US, performance is very similar for both these indices.

*illustration: ajay mohanty*

The report also charts the growing economic importance of the EM countries. From 1980 to 2018, the share of the EM countries has grown from 25 per cent of world GDP (on PPP basis) to 50 per cent today. Even as a share of world GDP on market exchange rates, these same EM countries now account for 35 per cent of world GDP, up from 18 per cent in 1980. These countries have about 60 per cent of the world's population. Yet despite their growing clout in economic and demographic terms, they only account for 11.5 per cent of world investable market capitalisation. Undoubtedly, this number has multiplied from about 2 per cent of world investable market capitalisation in 1980, but even at 11.5 per cent, the EM world is significantly underrepresented. What is also odd is that the weightage of world market capitalisation for these 24 large EM markets has been stuck at approximately this 11.5 per cent level since 2007. There has been no further progress or gain in share for the last 11 years. This stagnation has happened largely due to the underperformance of EM equities compared to developed market equities of nearly 55 per cent over the last 11 years. This underperformance is actually almost entirely versus US equities. As compared to world (ex US), EM performance is very much in line. Therefore, even though we have seen greater equity issuances in the EM universe through privatisation, IPOs and follow on offerings, the corresponding increase in market capitalisation and investable universe has not been large enough to compensate for the market underperformance. This will change over the coming decade, and one would expect the long-term trend of a rising share of global equity market capitalisation for EM should resume.

The report also tries to explain what are some of the reasons for the low weightage of EM equity markets in global indices. The reasons really come down to adjustments the index providers make to various equity markets to better reflect the actual investable universe available to investors. MSCI, for example, till 2018, did not include the China A share market in its calculations for China weightage, arguing that the markets were too difficult for global investors to access. This changed in 2018, with MSCI partially including the local China equity market, and their full weightage will get reflected over time. MSCI also adjusts markets for free float. If we see the top EM markets their average free float is only about 40 per cent, compared to 90 per cent for the developed world markets. MSCI also chooses to omit certain stocks because of free float and liquidity concerns. These omissions are far more prevalent in the EM world. Had the index providers not made all these adjustments, already today, instead of 11.5 per cent, the weightage of the EM world in global indices would be close to 25 per cent. India in fact suffers very badly from the free float adjustment, with MSCI adjusting our market capitalisation sharply downward to reflect the low free float of our listed universe. This is something we need to address if we ever want to get India closer to its fair weightage in the relevant indices. A weightage better reflecting the size and clout of our economy and markets.

The report then goes on to look at long-term asset returns across most global markets. This is probably the longest duration and most comprehensive data series on financial asset returns produced by anyone.

Looking at long-term data for US financial assets, we come to some interesting conclusions. Taking the 119-year history from 1900 to 2018, equities in the US produced nominal returns of 9.4 per cent annualised, compared to 4.9 per cent for bonds and 3.7 per cent for bills (proxy for cash). Looking at real returns, equities delivered 6.4 per cent, bonds 1.9 per cent and bills about 0.8 per cent. Equities were far and away the best performing asset class over this period. Just to give a sense of scale, in real terms $1 invested in equities in the year 1900 would be worth more than $1,500 by the end of 2018. For bonds the same $1 over the 119 years would be worth about $10 in real terms.

Equities outperformed bonds and bills in all markets, over the 1900 to 2018 period, and delivered positive real returns of 3 to 6 per cent across all major markets. What is however surprising is that since the year 2000, across all the major markets, equities in real terms have underperformed bonds. A total reversal of the long term picture. In the US, for example, since 2000, equities have delivered real annualised returns of 2.9 per cent compared to 4.6 per cent for bonds. In the UK, since the year 2000, equities have delivered real annualised returns of 2 per cent compared to 4.1 per cent for bonds. Admittedly, the starting point for this is the peak of the dot-com bubble, and thus you have a base effect to contend with, but still surprising to see equities underperform bonds for 19 years, of which the last 10 have been an equity bull run. You can see why many feel that we are at the end of a bond bubble and that bonds are the asset class which is absurdly overvalued not equities.

While this data may not be fully relevant for India, it is important to know to develop a sense of perspective. From a global and historical point of view what is a strong real return for equities? What level of equity risk premium is the minimum you should demand as an equity investor? As India continues to globalise, we will also most likely come into sync with these metrics with other markets around the world.

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