PICTET 1805

Caution still called for despite tumbling records

Comments on the long-term performance of equities and bonds

Rainer Gänsslen (Pictet Wealth Management) | January 2018

Market review of 2017

Swiss equities

The Swiss equity market, as measured by the broadly diversified SPI, ended the past year with a performance of +19.9%. This was not an absolute record but still the third-best result since the financial crisis in 2008.

The Swiss equity market has thus joined the ranks of the major stockmarkets in terms of trends: The S&P500 and the Nasdaq closed the year up just under 22% and 30% respectively. As measured by the Nikkei, the Japanese equity market was also up by a solid 21%.

The very strong performance of the global economy and continued expansion of monetary policy worldwide had a marked positive impact on the Swiss equity market. All of this happened despite a number of uncertainties (the action of the American government, elections in France and Germany, the continuing lack of clarity over Brexit, but also political tension between Russia and Turkey, the USA and North Korea as well as the still-unresolved Syrian conflict).

Swiss investors were, however, faced with currency fluctuations – some of them substantial – on their foreign investments: Investments in US dollars suffered a currency loss of approximately 4%, while investments in yen lost almost 1%.

Swiss bonds

What we can say about the Swiss bond market is virtually the contrary of what we have said about the Swiss equity market. Last year saw the second-worst performance in the past 10 years. The Swiss Bond Index, which reflects a portfolio of first-class domestic bonds with an A-AAA rating, posted a slight loss of 0.04%.

Inflation

There is some positive news here as we are seeing mild **inflation** again in Switzerland. Prices rose by 0.8% in 2017. The average annual inflation rate over the last year was +0.5%. We can therefore look back on the first year since 2011 when average annual inflation was always positive.

Long-term results

In our long-term review since 1925, shares have reached a new high (both in nominal and real terms). Because of the (slightly) negative result for bonds, the previous all-time high was reached last year.

In our comments on the 2011 results (equities recorded a 7% loss and bonds a gain of 7%), we concluded that as a long-term investor you also have to catch a falling knife once in a while: we felt that while caution was appropriate, panic-exiting the stockmarket was not. And the ensuing years were to prove us right. After the three years that followed, with in some cases high double-digit overall returns and a rather disappointing 2015, we spoke of the thrill of the roller coaster ride and came to the conclusion in the following year that doing nothing was not an alternative either.

What we can advise investors today who want to invest their money

The historical data speak for themselves: over investment periods of more than 13 years, investments in Swiss equities have never posted a negative return.

We have prepared a visualisation in the form of a yield triangle; this can be downloaded from our homepage (http://langfriststudie.pictet).

Figure 1 is an extract from the Pictet yield triangle. The chart shows the annualised performance for each investment period from the beginning of 2003 to the end of 2017.

The white diagonals separate 5- and 10-year investment periods.

Examples:

Those who invested in the Swiss stock market at the beginning of 2008 were able to record an average annual performance of -6.3% in this four-year period at the end of 2011.

Figure 1: Extract from the Pictet yield triangle

Kauf zu Beginn des Jahres →	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003
2003															22.1
2004														6.9	14.2
2005													35.6	20.4	20.9
2006												20.7	27.9	20.5	20.9
2007											-0.1	9.8	17.8	15.0	16.4
2008										-34.0	-18.8	-7.3	1.9	2.9	5.9
2009									23.2	-9.9	-6.7	-0.5	5.8	6.0	8.2
2010								2.9	12.6	-5.8	-4.4	0.2	5.4	5.6	7.5
2011							-7.7	-2.5	5.4	-6.3	-5.1	-1.2	3.4	3.8	5.7
2012						17.7	4.2	3.8	8.3	-1.9	-1.6	1.3	5.1	5.3	6.8
2013					24.6	21.1	10.6	8.6	11.4	2.1	1.8	4.0	7.1	7.1	8.3
2014				13.0	18.7	18.3	11.2	9.5	11.7	3.6	3.1	4.9	7.7	7.6	8.7
2015			2.7	7.7	13.1	14.2	9.4	8.3	10.3	3.5	3.1	4.7	7.2	7.2	8.2
2016		-1.4	0.6	4.6	9.3	10.9	7.6	6.9	8.8	2.9	2.6	4.1	6.5	6.5	7.5
2017	19.9	8.7	6.7	8.2	11.3	12.4	9.2	8.4	10.0	4.5	4.1	5.4	7.4	7.4	8.3

Verkauf am Ende des Jahres

Source: Banque Pictet & Cie SA; Pictet Wealth Management; http://langfriststudie.pictet

(see ❶ Figure 1). Similarly, we saw average performances of +18.3% (-) and +10.3% (-) for the years 2012–2014 and 2009–2015, respectively.

Our analysis of historical returns shows that no losses were incurred in these periods with equities for investment periods of more than 13 years.

It is also interesting here to look at the distribution of returns over different investment periods.

Figure 2 shows the distribution of equity market yields over 5-, 10- and 15-year periods.

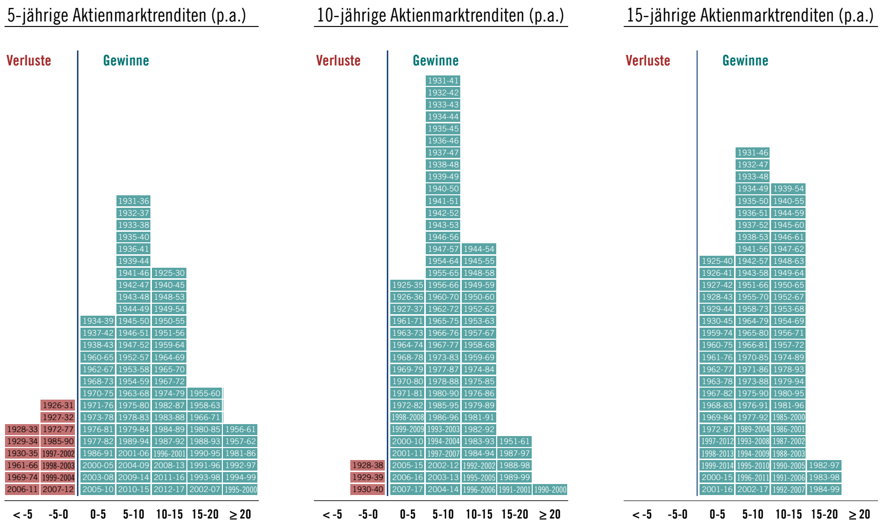
This chart underlines our conviction that investors with a long-term outlook and a corresponding willingness to take risks should hold a high real value share in their portfolios: While there were a number of 5-year investment periods in which losses occurred, the number of 10-year investment periods in which losses occurred was significantly lower. And over 15-year investment periods, there were no longer any investment periods at all when shares would have resulted in losses.

But investing in ETFs – which has recently come into vogue – is not without its risks either.

Figure 3 shows the performance of six different indices for the Swiss equity market, for which ETFs are offered.

Studies have long indicated that selecting an ETF (or the underlying index) is also an active investment decision. Figure 3 illustrates this with stark clarity: Over the last three years there has been a cumulative performance difference of almost fifteen percentage points between the six indices considered.

Figure 2: Distribution of returns over different investment periods



Source: Banque Pictet & Cie SA; Pictet Wealth Management; http://langfriststudie.pictet

Risks and secondary effects

As is always the case on capital markets, "*there's no such thing as a free lunch*". In other words, the long-term advantage of equities goes hand-in-hand with higher fluctuations in equity market yields.

We therefore need to exercise some caution as far as the high returns obtained on equity markets in recent years are concerned. The monetary policy of recent years is being increasingly pared back: The Fed is already tightening its monetary policy reins, and the ECB is also thinking about ending its bond purchasing programme. Political uncertainties and geopolitical tensions could have an impact on the markets as well.

While the fundamentals remain positive overall, we expect the fluctuations to increase in 2018.

Short-term fluctuations but long-term "security" in terms of a significantly higher average performance of shares compared with bonds. But is it really that simple?

Investors should not confuse the long-term advantageous element of holding shares with the buying and selling of shares.

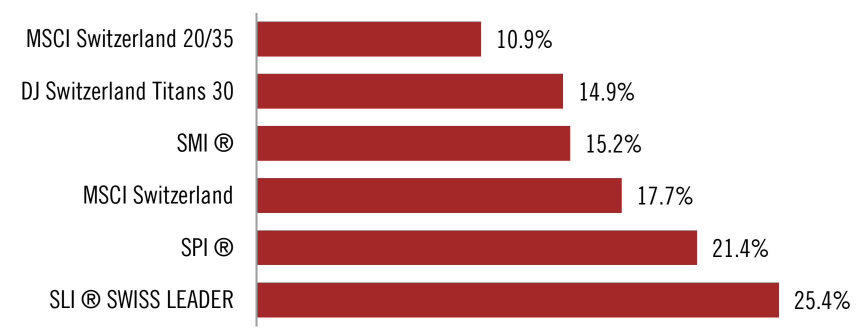
Numerous examples from the past show that this type of investment can result in high losses.

Conclusion

Despite the already very strong performance of markets in recent years, we believe investors should continue to implement an equities quota based on their individual risk profile.

The long-term results of our study back up this view: after all, there have been a number of far-reaching crises over the past nine decades. If they had a

Figure 3: Trends of various indices for the Swiss stockmarket [1)]



Source: Banque Pictet & Cie SA; Pictet Wealth Management; Datastream; Bloomberg
1) Cumulative performance in Swiss francs for the period 31.12.2014 – 31.12.2017

sufficiently long investment horizon, however, investors were still able to ride out short-term losses.

From a tactical and forecast-based perspective, we have also come to the conclusion that risky tangible assets continue to show room for improvement in view of the fundamental data.

At the same time, we also see short- to medium-term risks with bonds: If inflation does gain significant momentum, we can expect rising interest rates, resulting in losses in the book prices of bonds.

Author:

Rainer Gänsslen has been working at Pictet for more than 18 years as a family office expert. In this role he is responsible for giving conceptual and tactical advice to very wealthy private individuals and institutional investors regarding the entire investment process. His tasks include preparing strategic asset allocations, organising investments, constructing portfolios and overall investment monitoring. He also helps his clients set up customised invest-ment solutions and structures. In addition, he coordinates, monitors and optimises the global investment activities of his clients. His clients include high net worth individuals, global family offices and institutional investors in Germany and abroad.

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