SA equities live up to the promise of outperforming cash by 7.8% a year

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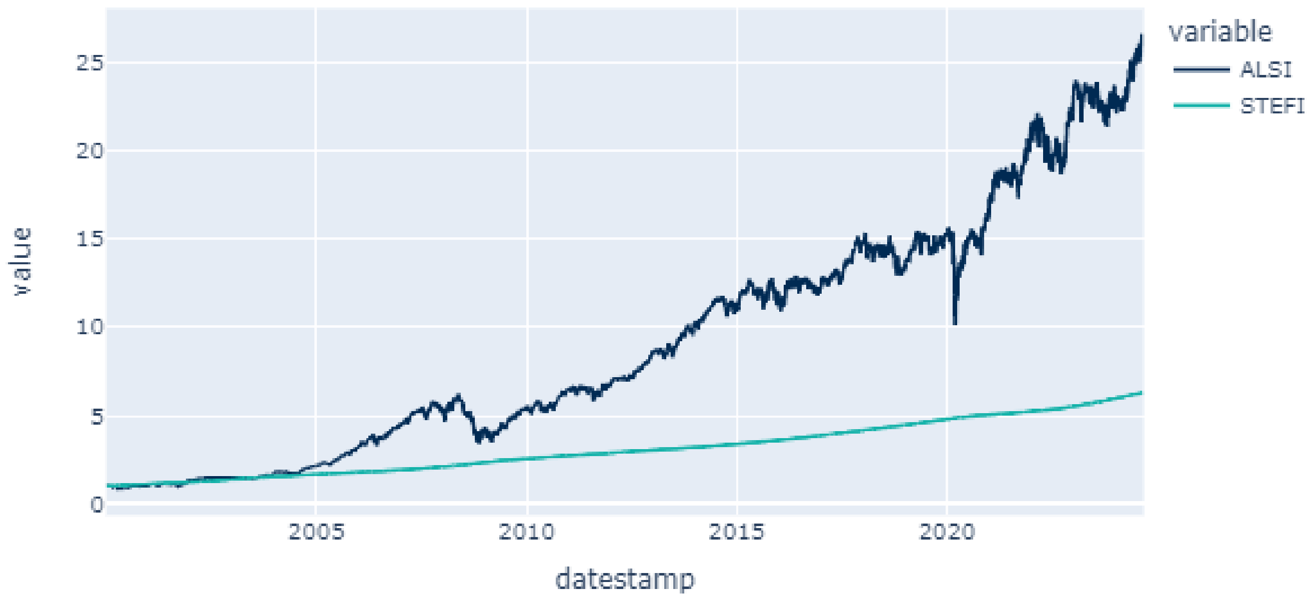
Equity investments have long captivated investors with their promise of substantial returns compared to other asset classes. The latest evidence shows that they live up to this promise, substantially outperforming cash over the long term and underperforming less often than expected.

That may seem surprising during a year that has reminded investors of the heightened risk and uncertainty of investing in stock markets. However, history shows that over the long term, you can expect to outperform cash by 7.8% each year.

On a cumulative basis, that amounts to considerable outperformance, as shown in the graph below, which illustrates the cumulative return comparison between SA equity (ALSI) and cash investments (STEFI) since January 2000.

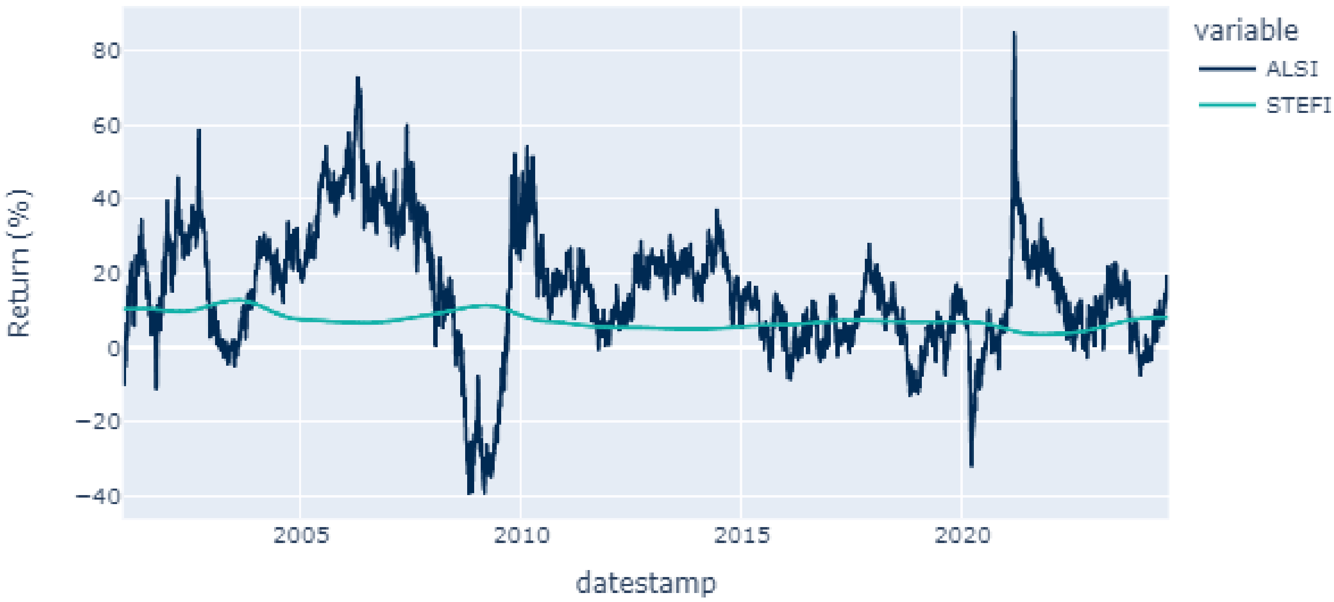
Total Return Index



Source: Prescient Investment Management, Bloomberg Sep 2024

While the evidence is clear that equities have outperformed cash over the long term, understanding the volatility of these returns over shorter time horizons reveals a more nuanced picture of the associated risks, as shown in the graph below.

Rolling 1 year return of ALSI Tr vs STEFI



Source: Prescient Investment Management, Bloomberg Sep 2024

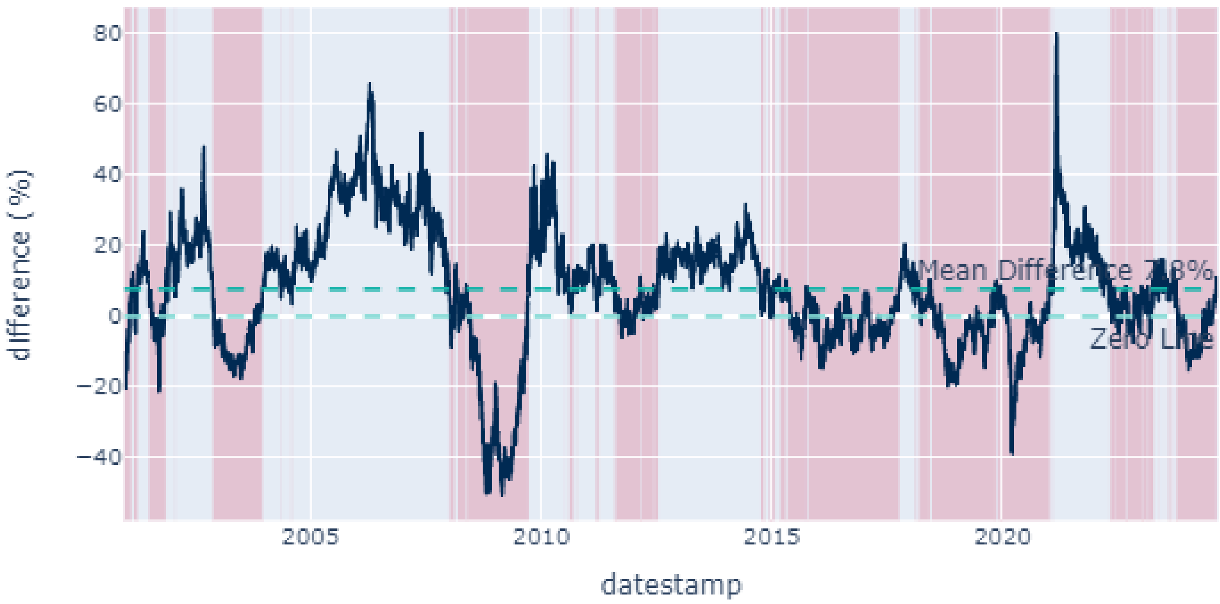
The short-term volatility of equity investments can be striking, with some periods falling as much as 50% below cash returns over just one year. Such dramatic dips can understandably dishearten investors, making them consider shifting to safer asset classes. However, the average return above cash remains a significant 7.8%. This means you can expect to outperform cash by 7.8% each year since Jan 2000.

Equity investment horizon is shorter than you think

Even more compelling is that equities tend to rebound to or exceed this average return after each dip. This begs the question: based on history, what is the minimum time period you need to hold onto your equity investments to be rewarded for taking these risks?

The graph below highlights the periods when equity did not achieve 7.8% above cash. It's important to note that we are highlighting the areas where returns fell below 7.8% above cash, not below 0%.

Rolling 1 year difference in return of ALSI Tr vs STEFI

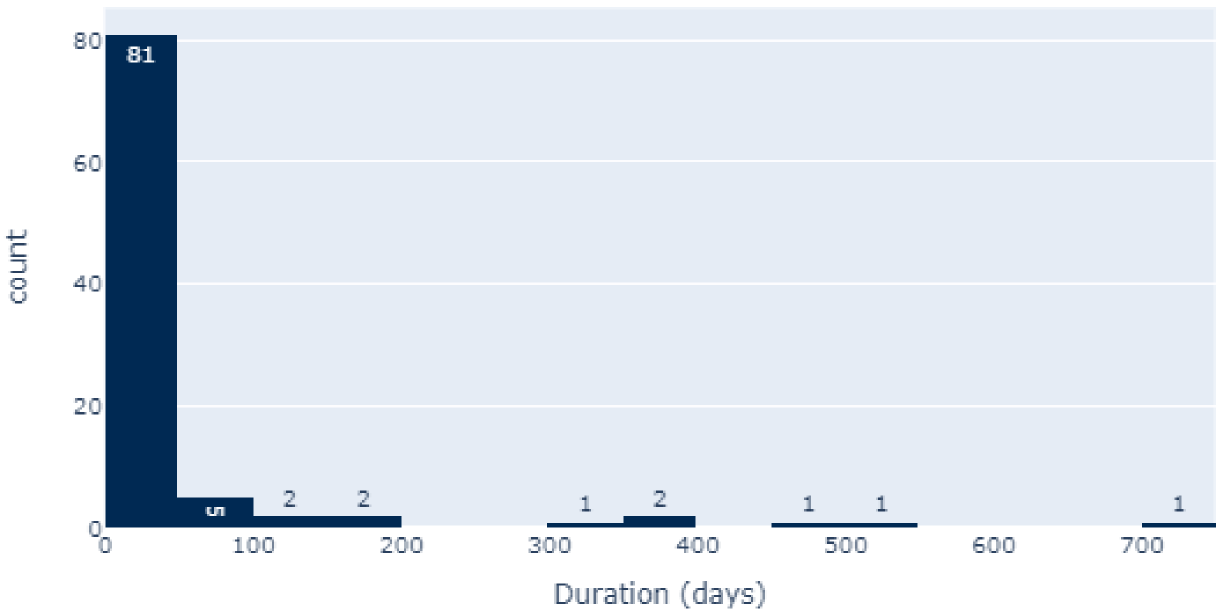


Source: Prescient Investment Management, Bloomberg Sep 2024

The longest period of underperformance compared to cash was just two years, from 2015 to 2017, and the second longest was from June 2018 to November 2019. During these periods, investors were not sufficiently compensated for the risk taken. However, after these periods, investors continued to enjoy the expected superior returns to cash.

Achieving these results relies on an investment approach that is benchmark cognisant and well-diversified, key principles at Prescient. Drifting away from these principles in the equity space raises the risk of underperforming the benchmark, exposing the investor to the higher risks associated with equities without benefiting from the returns they should be achieving from the asset class. Additionally, the investor risks further eroding the benefits of investing in equities if the investment vehicle is not cost-efficient.

Periods of underperforming 7.8%



Source: Prescient Investment Management, Bloomberg Sep 2024

Analysing the historical distribution of periods when equities delivered returns of less than 7.8% above cash reveals a striking insight: We can be 95% confident that equities will surpass cash returns by more than 7.8% if held for just over 330 days—remarkably, that's less than a year!

US equities consistently outperform cash by a smaller margin

The historical performance of US equities tells the same story, with investors benefiting from annual average returns of 6.7% above their respective cash investment rate, Secured Overnight Financing Rate (SOFR). The longest period of underperformance 6.7% above cash was from 2000 to 2003 after the dot-com bubble. We can conclude that this phenomenon is not geographical but rather asset-class-specific.

SA bonds offer narrower outperformance and shallower drawdowns

Rolling 1 year difference in return of ALBI vs STEFI

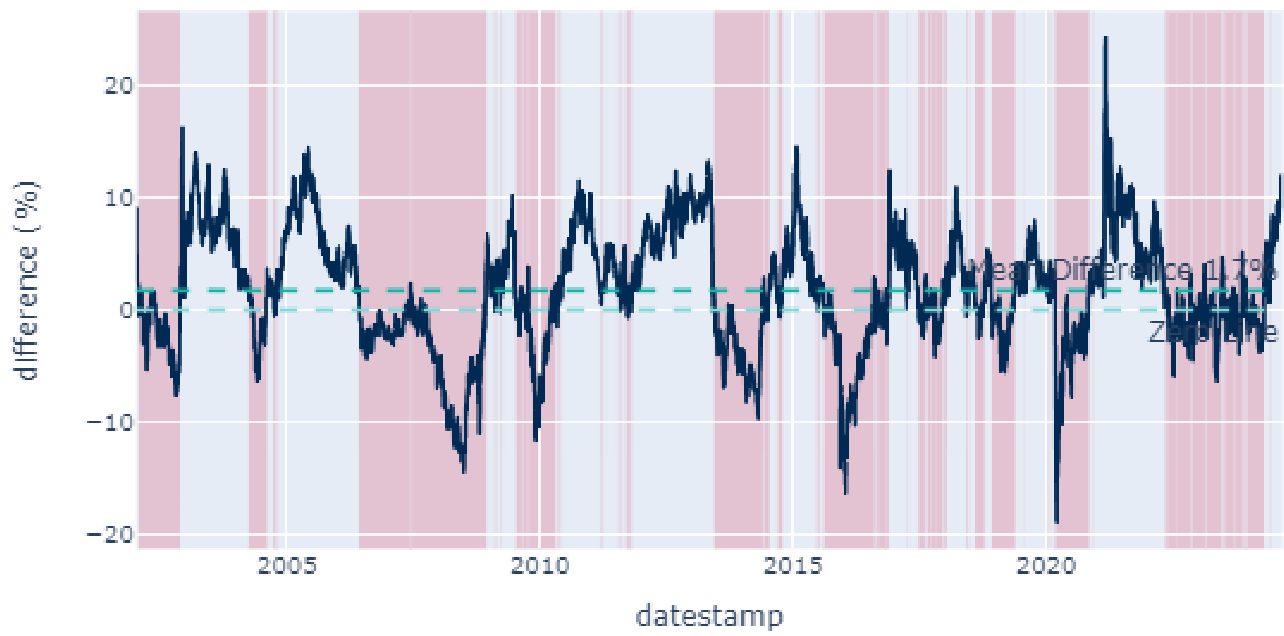


Figure 5. Source Prescient Investment Management, Bloomberg Sep 2024

SA bonds (proxied by the ALBI) outperform cash on average by 1.7% a year. As expected, the performance drawdowns are shallower and shorter than for equities, with the most significant underperformance over a one-year period just under 19%. The outperformance in this asset class is primarily generated from the term premium instead of the All Share Index's equity risk premium.

While the path of equity investments may be fraught with short-term volatility, the evidence shows that the long-term rewards of investing in equities significantly outweigh the risks. In South Africa, the longest period investors have not benefited from equities' average annual historical outperformance of cash has been about two years. In the US, it has been three years.

This level of outperformance may be surprising to some, and the investment horizon may be shorter than is generally factored into financial advice. However, it shows that equities shouldn't be underestimated and deserve a rightful place in any portfolio that aims to create long-term wealth.

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Nicholas joined the Prescient Graduate programme in January 2022. He acquired a full-time position at Prescient Investment Management as a Quantitative Analyst in the equity team in November 2023. His responsibilities are dynamic in the quant space of the equity team, including advancing research efforts, developing fund models, and enriching the proprietary investment portal.

With two years of experience in the industry, Nicholas spent 6 months at Prescient Fund Services in the risk and performance team. He also spent 10 months at Prescient Securities working as a Quantitative Analyst assisting the derivative and FX desk.

Nicholas holds a BCom Actuarial Science (Hons) from the University of Stellenbosch.