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NEWSLETTER

The silver lining to a decade of wealth destruction

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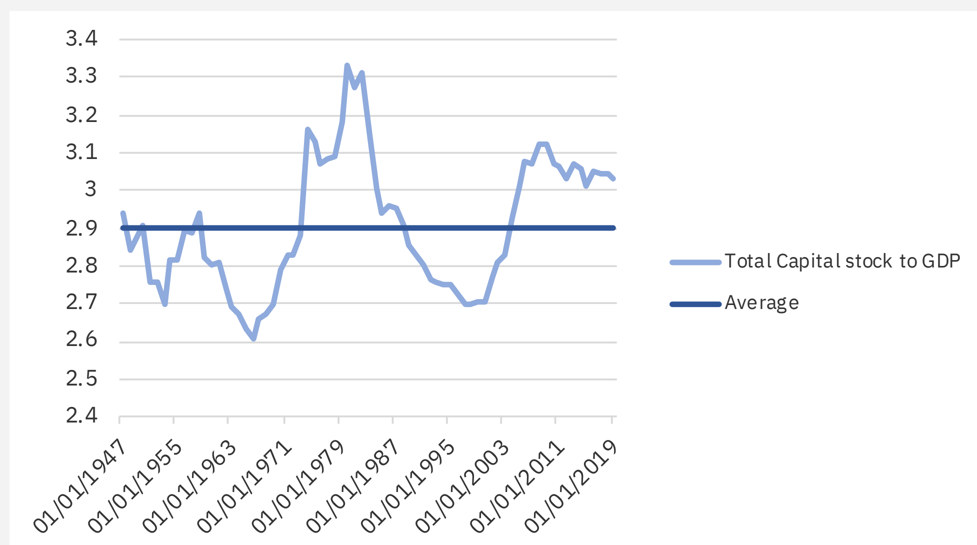
"Only buy something that you'd be perfectly happy to hold if the market shuts down for ten years."
Warren Buffett

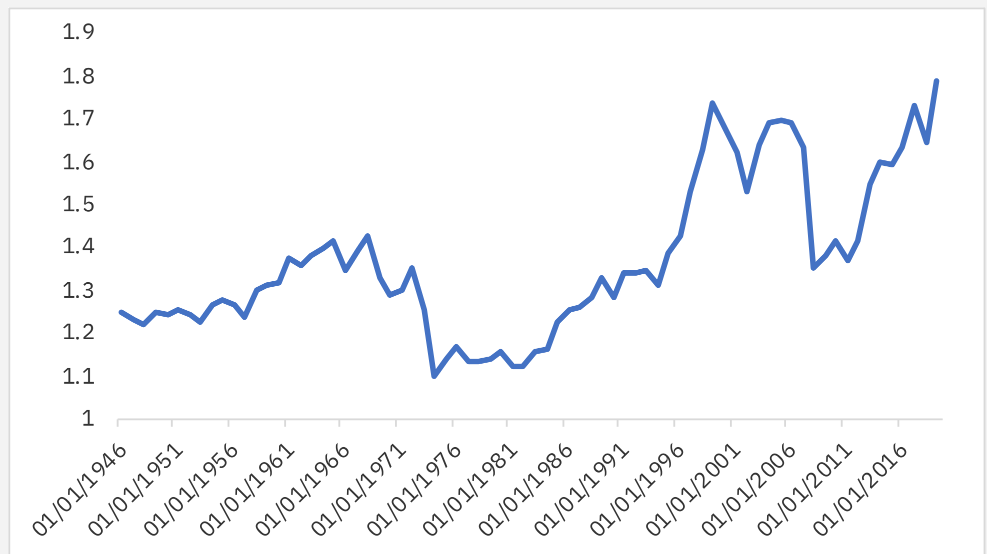
The long-run return on financial assets is intrinsically linked to the return on underlying capital. The capital stock of an economy can be thought of as cumulative investment less capital depreciation. In the United States the capital stock (at current cost), relative to GDP, has oscillated between 3.5x and 2.6x over the past 70 years. It currently stands at 3.1x – slightly above its long run average – and trending modestly down, implying a marginal return on capital slightly higher than the average. In a market economy, this ratio should be mean reverting, as too much capital leads to lower returns on capital, stimulating consumption over savings and vice versa.

Chart: US Capital stock to GDP ratio 1947-2020.



Investors, however, do not necessarily have the chance to buy into the capital stock at the current cost. Listed equities, for example, currently trade at a big premium to book value and even private equity, often pays a premium to the underlying capital. While the capital stock of the United States is not bloated like China's or Japan's relative to output, the valuation investors are being asked to pay is extreme. The chart below shows the market value of the total capital stock relative to the current cost of the capital stock.

Chart: US Capital stock – Market value / current cost (x)

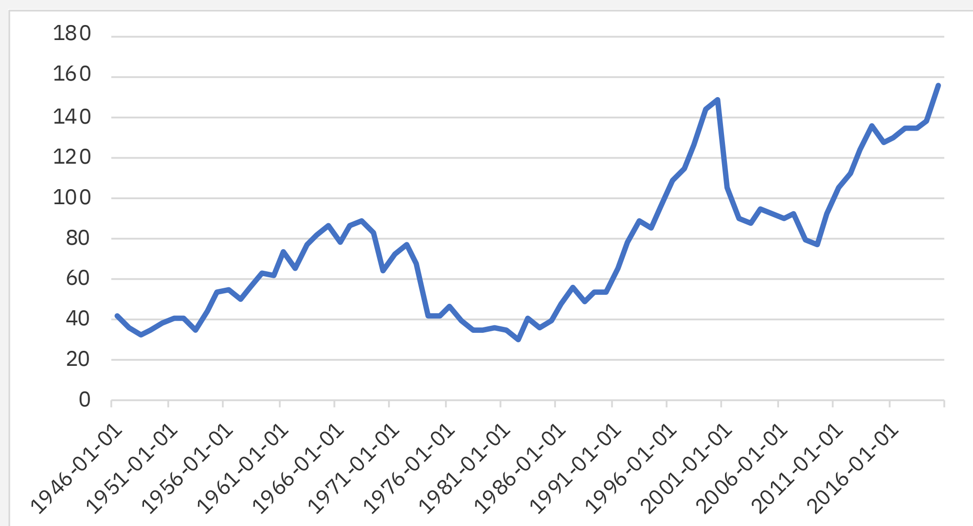


From the end of WW2 till 1995, this ratio was in a range of 1.1x to 1.4x. The big draw down in equities from 1965 through to the early 1990s (measured in real terms) and the performance of bonds during the inflationary late 60s and 1970s explain the fall from the highs of 1965 to the lows of the 1980s. Falling discount rates and the great moderation led to a re-rating of the capital stock through the 80s and 90s aided by increasing leverage. The easy monetary policy in the wake of the emerging market crisis of 97 and 98 and the run-up to the Y2k fears explain the millennium peak. The bursting of the TMT bubble; the housing bust from 2005 onwards; and the GFC brought the ratio fleetingly down into the normal range. Since then, QE has inflated the market value / current cost ratio to a new high. There are broadly speaking two major components to the premium: the market value of corporate net worth vis a vis the net worth on a current cost basis, and the market premium for the residential housing stock.

Since most institutional investors do not directly buy residential

housing, we will focus on corporate equities. The chart below shows the re-rating, to unprecedented levels, of the market value of non-financial corporate net worth vis a vis its current cost. As we point out in "US equities: What does the next 10 years have in store?" the four years around the millennium, the last time we were close to current levels, were associated with negative real returns over the subsequent 10 years and ten-year negative real returns have been initiated from far lower valuation levels than now.

Chart: Non-financial corporate equities: Market value / Net worth (%)



In aggregate, it would therefore appear highly likely that, in real terms, even with dividends re-invested, investors will lose money over the next decade in US equities. Given that US 10 year bond yields are around 1% and the federal reserve are targeting inflation at 2%, Government bonds are probably not the answer either. It has been reported that there are now about USD 18 trillion of negative yielding bonds globally, and it appears that only a very small fraction of fixed income instruments carry a yield above Fed's target inflation rate. Given that there are about USD140 trillion of bonds outstanding in the world and the global market cap is converging in USD100 trillion there is therefore the potential for incredible wealth destruction in real terms over the coming decade. Central banks will do their best to ensure it is only "real" and not nominal.

The good news is that, with such potential for losses in the aggregate asset classes and equity indices, it could be argued that there has never been a better time to be an active manager of capital. The premium that savers are prepared to pay for outperformance should rise as passively managed wealth is destroyed. By its very nature, passive investing creates opportunities for active managers. According to data from Morningstar, by 2019 almost half US equity mutual fund money

was managed passively. Morgan Stanley Capital International, which to many people is the epitome of a company that has ridden the passive / benchmarking wave better than most, currently is capitalized at USD33bn or USD10 million per employee. With so much money not even trying to outperform, there is surely at least a chance to earn positive real returns in the next decade for those that attempt it. Passive investors face the prospect of a decade of wealth destruction. Consequently in could be argued there has not been a better time to be an active manager of capital in the past forty years – the premium savers should be prepared to pay for performance should never have been higher.

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