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by Standard Chartered's Chief Investment Office

Investing across generations

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A client recently asked us an interesting question about long term investing – if one wishes to pass on an inheritance to the next generation, should it be fully invested in equities alone?

At face value, there is a temptation to say yes. Equities, as is often repeated, have historically outperformed other asset classes 'in the long term' and, so the argument goes, the inevitable volatility along the way should not matter over such a long time-horizon. However, as we argue below, there are a few things that could go wrong with such an approach. While the appropriate allocation will always differ from one situation to another, in most cases a somewhat more diversified allocation could end up being a more prudent approach.

Preserving wealth for the next generation

There is no shortage of studies that show equities outperformed bonds and cash over long time-horizons in the post-World War II period. One of the most famous studies in this space – Jeremy Siegel's 'Stocks for the long run' – uses considerable US market data to show that, over a sufficiently long period, equities have done a better job of delivering inflation-beating returns than (government) bonds, gold or cash.

Does that mean we should allocate to equities alone for the long run?

Will our nerves be as strong as financial history?

Possibly one of the biggest risks to such a strategy is that an all-equity strategy would make us more susceptible to making a behavioural mistake. To provide just one example, the global equity index fell almost 60% from its October 2007 peak to its March 2009 trough.

Looking back at history, we now know that the correct action for a buy-and-hold investor with a multi-decade horizon would have been to do nothing. However, amid the screaming headlines at the time, would we honestly have been able to avoid making the mistake of selling some, or all, of our holdings in panic? In a bull market, it is easy to say we would not. Nevertheless, there are countless anecdotes of investors who failed to hold their nerves at that time: selling close to the market low and exacerbating the situation by not reinvesting to take advantage of the subsequent equity market rebound.

Most diversified investment allocations would have fallen over that period as well. However, a diversified allocation across equities, bonds, gold and cash would have fallen by much less than 60% and gains in asset classes like bonds and gold would have offered opportunities to take profit and rebalance into equities as they fell. This would not only have reduced the chances of making an investment error, but possibly even created a situation where rebalancing would have led one to add to equities at an opportune time.

Other pitfalls

Beyond making a behavioural mistake, we should also be wary of three risks of focusing on equities alone.

1 **First, many studies highlighting the historical outperformance of equities over long horizons focus on equity indices.** This means that, while the conclusions of the study would apply if implemented through mainstream equity indices, implementation via anything more specific – sectors or specific stocks, for example – would introduce additional layers of complexity that could lead to a very different outcome, including the risk of permanent loss. For example, of the 'Nifty 50' stocks popular in the 1970s in the US, many are no longer even publicly traded.

2 **Second, most available research use US data, sometimes with a disproportionate focus on post-World War II history.** It is plausible that the experience outside the US may not be exactly the same. Other studies have also argued that pre-World War II data shows performance between equities and bonds was much more evenly matched. While much of this may seem like ancient history, when considering investment allocations targeted at multi-decade horizons, it is fair to question whether the next fifty years will indeed look like the last fifty.

3 **Third, a broad-sweep characterisation of equities and bonds can hide many opportunities a level or two down from these large categories.** For example, our long-term expected returns show that asset classes like Emerging Market local currency bonds or listed infrastructure could offer long-term returns competitive with global equities, while offering diversification benefits.

Maximising one's chances of success

A lot can happen over a long time-horizon, and while history is often a useful guide, it is far from guaranteed that future decades in financial markets will look exactly like past ones. For investors, while a large allocation to equities makes sense over such long time-horizons, we believe a reasonable amount of diversification can help mitigate the journey's risks and maximize the investment returns.

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