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The Role of Equities

Why equities matter

Equities are an important component of a properly diversified portfolio. Ideally, equities would sit alongside with other asset classes like fixed income, real estate, cash, among others. Asset allocation is the thoughtful and precise method by which equities are risk-balanced with other asset classes in a client's portfolio to reflect that client's set of needs and risk tolerance. The intention is to spread capital across a variety of asset classes that can contribute to returns and manage risk in different ways. The asset class that we most often look to for growth is equities.

Arguably, globally diversified equities should be a core component of a long-term investor's portfolio. With a history of almost a hundred years, the US stock market, for example, has shown that owning equities for the long-term can meaningfully contribute to wealth accumulation. Not all, but some equities also pay a meaningful dividend, which can help satisfy a client's cash flow needs as well. Equities are also one of the investor's greatest tools in protecting themselves from the long-term effects of inflation. However, why is it possible to feel like you're running towards something, yet wanting to run away from it at the same time? If you are in private practice, this is like getting a case that you find intellectually stimulating, but also with some level of risk, and of course, a ton of work. That is exactly how many investors feel about equities. In the short term, investors sometimes want to run away from equities, but often don't because they understand the long-term benefits.

Capital appreciation

There are two sources of returns to equities; the first comes by way of capital appreciation. This is the classic case of buying low and selling high. Although it may not be easy to always get the timing right, on the long run equities have been among the highest returning asset classes. Equities are a return seeking asset

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class. To realize returns, risk is inherently part of the same experience. Therefore, when comparing broadly diversified risk-adjusted portfolios, the greater the level of risk, the greater level of expected return.

Equities are the growth engine of your portfolio. If properly vetted and diversified, a core holding of globally diversified equities should be the primary driver of long-term portfolio returns. Most of long-term wealth accumulation comes from the appreciation of capital, meaning, there will be an increase in the price of the investments you own.

A focus on capital appreciation also helps you accumulate wealth in a tax-efficient manner. Equities allow you to decide exactly when to realize taxable gains, which provides you with further control over your long-term wealth accumulation.

Dividend income

The second source of return to equity investors is dividend income. While dividend income may not be the primary contributor to long-term returns from equities, dividends provide a meaningful benefit. Younger companies that are still either proving themselves, or in growth mode, are unlikely to pay dividends because the money is often reinvested within the company. Companies that are more mature and have been successful in creating free cash flow are able to pay a dividend to shareholders, which in turn attracts certain types of investors. Retirees, pension plans, insurance companies, are all among the largest investors in dividend-oriented equities. This is because receiving steady cash flow every year creates both an opportunity to re-invest it or use it to offset ongoing expenses.

Dividends are an important component of the returns that equities generate in a properly diversified long-term portfolio particularly for fixed income investors. Dividend income provides a steady reliable stream of cash that can satisfy a variety of different needs. Reinvesting dividends can provide a meaningful accretive benefit to long-term wealth accumulation. Retirees have long since praised companies that are able to pay ever-increasing dividends to meet their retirement spending needs.

Inflation protection

There are at least three great unknowns for a long-term investor: How do I protect against deep and prolonged bear markets? Will my assets be able to keep up with inflation? Will my assets outlive me, or will I outlive my assets?

To accumulate and protect wealth, our assets should keep pace with or out-run inflation. Equities are one of the asset classes that has the best opportunity to do so over time. Real growth should come by way of real returns. Meaning, the portfolio return minus the rate of inflation equals real return. Over time, equities should be able to exceed inflation by a meaningful amount to create 'real' or 'inflation-adjusted' growth.

This is important because inflation is a silent destroyer of wealth. If inflation were currently 3% for example, then compared to January 1st, a $100 bill in your pocket would only be worth about $97 on December 31st. This is because inflation has robbed that hundred-dollar bill of 3% of its purchasing power over the course of a full year. While 3% in one year may or may not seem like a lot to you, over five, ten, twenty, thirty years, it is cumulative. For your assets to have any chance of either keeping up with, or outrunning inflation, the rate of return must be in excess of inflation both on average and over time. Equities have historically demonstrated the ability to hedge against the eroding effects of long-term inflation.

Equities provide growth and diversification

The role of equities is to provide both long-term growth and diversification. During times of financial stress, it is tempting to run away from equities because of the volatility and the psychological anxiety that may ensue. This is typically the worst possible mistake a long-term investor can make. By staying in equities and especially contributing to portfolios, investors are essentially running toward equities when it is most uncomfortable to do so. This is not by accident. Successful investors understand this is because of the role of equities play in providing portfolio growth, income, and inflation protection.

Call/email me for additional insights or for more information.

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