MV Capital Management Thought Leadership

Are Equities a "Cult"?

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Thirty three years ago, in August 1979, Business Week magazine trumpeted the demise of the stock market in an article titled "The Death of Equities". Somehow it always seems that these types of grandiloquent proclamations are perfectly timed…to be spectacularly wrong. The Business Week cover came before the longest macro bull run in the history of U.S. stock markets. Of course, right before that bull market ended we had the ebullient likes of "Dow 30,000" and other pronouncements of the arrival of the Eternal Investors' Paradise. We are quite confident that somewhere out there is a contrarian fund whose entire strategy is to go in the opposite direction of whatever message these periodic cover stories are touting.

So now along comes none other than the highly estimable Bill Gross, telling us in one of his recent commentary pieces that the "cult of equity is dying". Are we at one of those moments again, where a bold pronouncement about the market's future is doomed to the predictive ignominy of Business Week or Dow 30,000? We happen to have a great amount of respect for Bill Gross, and the commentary piece in which he makes these arguments is characteristically sober and rational, so we think the question bears some due consideration.

Why a Cult?

Gross doesn't say "equities are dying", rather he says that the "cult of equity is dying". Cult of equity? That by itself is a provocative turn of phrase, calling up images of high priests with black robes over their Hermès ties, chanting indecipherable mantras while luminescent stock charts and prices morph in and out of a dark cathode void of quantum randomness. But the choice of phrase is deliberate. Stocks aren't dying, and Bill Gross knows this. What is dying, according to his argument, is the core belief set of three decades worth of financial professionals, namely that stocks always outperform everything else over the long term – that even in a world where real gross domestic product is unlikely to top 3.5% investors can always expect to achieve the historical performance that stocks have delivered – which Gross cites as having been an average annual, inflation-adjusted (i.e. real) 6.6%. This mindset – the idea that for the next 100 years we can expect to earn real annual returns of 6.6% just like we did for the last 100 years – is what he calls the cult of equity, and his argument is that this mindset is dying.

If the Equity Cult Dies, What Lives?

At MVCM we generally have been skeptical of whatever variant of the "sunset for stocks" argument surfaces on any given day. Not because we are cultists – far from it! Our view is rather more simple – there is nothing mysterious or high-priestly or esoteric about stocks. Stocks are just the residual assets of a business – the net left over when you've subtracted everything you owe from everything you own. As long as there are businesses making things, and people buying things, there will by existential necessity be stocks. And there will be people to buy the stocks if they believe those businesses are likely to grow.

Aha, but what about bonds? Businesses issue bonds too, right? Maybe the cult of equity dies so that bonds may live, hmm? After all, Bill Gross is first and foremost a bond guy – maybe this is his nefarious way of arguing for the ascendency of the bond investor over the equity cult member? Alas, conspiracy theorists, no. Gross makes no such argument and actually takes great pains to make sure we understand that in his view both stocks and bonds face a future of diminished returns relative to historical performance. With the 10-year Treasury yield currently hovering not far from its all-time low it would be hard to make a straight-faced argument for a coming decade or two of bond dominance.

So if the future is notably less rosy for fixed income lenders and equity investors alike, who wins? Here is where Bill Gross ventures into somewhat less stable territory. Let's go back to that long-term real GDP figure of 3.5% that we talked about before. That, by the way, is a very solid number – it is referred to by economists and others in the know as the U.S. economy's "long term sustainable real growth rate". Gross takes this GDP number and divides it into four segments – we can think of them as competing claims on every dollar of economic output. There are returns to equity capital holders, returns to fixed income capital holders, labor (salaries and wages), and government (revenue, mostly from taxes). He presents a few charts to show why it is that equity returns (that 6.6% real average annual return) have done so much better than everything else. Real household wages have stagnated and then fallen, while government has acceded to a lower share of the pie through steadily declining individual and corporate tax rates (if you find that latter statement hard to believe, go back and check out what the top income tax bracket was in 1955 (hint: a great, great deal higher than today).

In the Next 100 Years…

So far so good. Corporate profits are high, household incomes less so, government taxes won't be doubling anytime soon, so it's been a better time, from an historical perspective, to be an equities investor than a salaried worker or a tax collector. One could almost be forgiven for developing a cult mentality around it…but our inclination is to say: so what? What evidence is there today that the piece of the total pie claimed by each of those four segments – equities, credit, labor and government – is going to be substantially different in the years and decades going forward? Maybe something seismic will happen at some point, but at this juncture it seems like pure speculation to us. There are plenty of reasons to believe that the equity share of the pie will be pretty robust going forward. We live in a global world where agility and mobility are key. Capital – and particularly equity capital – is more agile and mobile than either human labor or government. We think an awful lot would have to change for that equation to somehow radically reassert itself.

But what about the total size of the pie, as opposed to just those four pieces of it? Isn't the problem that the total size of the pie is going to be so much more modest that there is little hope of that 6.6% long-term rate of return repeating itself? Maybe – past returns are, after all, not a reliable guide to the future. But think about this: that 6.6% number spans a period of history that included the two most deadly wars ever fought, a sustained worldwide depression, periodic threats of nuclear annihilation…the 20th century was not exactly a bed of roses for much of its duration. And still – somehow we still managed that 6.6% return. Will it repeat? Maybe, maybe not. Is it impossible that it will repeat? Certainly not.

With warm regards,

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