Moving On Up

As the FTSE 100 Index stags past 7,000, we ask: what’s so different from 1999?

The FTSE 100 Index broke through 7,000 on 20 March 2015 (see Figure 1), the latest in a series of major world equity indices to reach record levels since the start of the year. Accommodative monetary policy from most of the world’s major central banks, including renewed stimulus from the European Central Bank, the Bank of Japan, and the People’s Bank of China, alongside reasonable, if not spectacular, global economic growth expectations, has supported the recent rally in equity markets. However, the arrival of these “milestones” has not been met with universal fanfare with some investors going as far as to describe the recent strong run by equity markets, which can be traced back to the market bottoming out in early 2009, as the “least-loved bull market of all time”.

Figure 1
Historical Value of the FTSE 100 Price Index (i.e. exclusive of dividends) up to 20 March 2015

[Graph showing the historical value of the FTSE 100 Index from 1987 to 2015]

Source: FTSE, RIMES Technologies

In this paper we discuss the implications of equity indices hitting these new highs and explore whether this, in itself, should be a trigger for investors to re-consider the size of their equity exposure.

The Trouble with Indices

The headline-grabbing news of equity indices hitting all-time highs has been a long-time coming. In the case of many of the world’s major equity indices it has taken close to, or over, a decade for them to beat their pre-financial crisis peaks (see Figure 2). Some indices, however, continue to remain well below their previous highs with the Japanese Nikkei 225 Index still trading at close to half of its peak levels of 1989, a time when the Japanese economy was in the midst of an asset price bubble.

Figure 2
Comparison of Current and Historical Index Values for Major Equity Indices

<table>
<thead>
<tr>
<th>Index</th>
<th>Date of Pre-2008 Index Peak</th>
<th>Date of Index Beating Pre-2008 Index Peak</th>
<th>Index Value at close 20 Mar 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTSE 100</td>
<td>30 Dec 1999 (6,930)</td>
<td>24 Feb 2015</td>
<td>7,023</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>9 Oct 2007 (1,530)</td>
<td>28 Mar 2013</td>
<td>2,108</td>
</tr>
<tr>
<td>Dow Jones Industrial Average</td>
<td>9 Oct 2007 (14,165)</td>
<td>5 Mar 2013</td>
<td>18,128</td>
</tr>
<tr>
<td>DAX</td>
<td>16 Jul 2007 (8,106)</td>
<td>3 May 2013</td>
<td>12,039</td>
</tr>
<tr>
<td>Nikkei 225</td>
<td>29 Dec 1989 (36,916)</td>
<td>N/A</td>
<td>19,560</td>
</tr>
</tbody>
</table>

Whilst it has taken a number of years for many of these indices, in nominal terms, to surpass their pre-2008 levels, in real terms (i.e. accounting for inflation), many of these indices remain well below their previous peaks. For instance, if the FTSE 100 Index had matched inflation (and typically we would expect equity markets to beat inflation over a full market cycle) since it hit its pre-2015 high on 30 December 1999, it would by now have surpassed 10,000.

Another aspect to consider is the different methodologies that are used to construct indices. For instance, whilst the DAX Index includes the impact that the re-investment of dividends has on returns, the FTSE 100 Index and Nikkei 225 Index do not. Similarly, the FTSE 100 Index is a market capitalisation-weighted index whilst the Dow Jones Industrial Average is a price-weighted index. These factors have impacted the timing of when certain indices have surpassed previous peaks but, in our view, this has little bearing on whether an equity market is over- or undervalued.
Musical Chairs

Another problem with using milestone index levels as a gauge of the attractiveness of current equity valuations is that they fail to account for how the constituents of an index may have evolved over time. For instance, over half of the names which made up the FTSE 100 Index at the end of 1999 were no longer in the index by the start of 2015.

Many of the index changes witnessed over the last two decades can be linked to changes in the global economic environment. A number of major equity indices saw a significant reduction in their weightings towards the technology sector at the start of the century following the collapse of the dot-com bubble. Marconi Company, a telecommunication company and the tenth largest holding in the FTSE 100 Index at the end of 1999, suffered the ignominy of falling out of the index and ceasing to exist by 2006. The landscape of the banking sector, a mainstay of a number of major stock markets, was also fundamentally altered by the global financial crisis which saw a number of banks file for bankruptcy or fall into public ownership.

Outside of these sectors, we have also seen a consolidation of a number of other listed companies through mergers and acquisitions (“M&A”) activity. This has led to a number of companies leaving major equity indices in recent years. Iconic British brands, Cadbury (now owned by Kraft Foods) and Boots (now owned by a private equity firm), are two examples of M&A activity which has fundamentally changed the make-up of the FTSE 100 Index in the past decade. Another key development has been the increasing number of overseas companies, such as the commodity trading and mining company Glencore, who have listed their business on multiple major stock exchanges. This trend has had the impact of significantly altering the make-up of many major equity indices.

The above factors have had a significant impact on how an index in 2015 might differ from how it looked in the past, both in terms of its constituents and also in terms of its sector breakdown. Due to these changes, comparing an index value today with one from a decade ago seems somewhat misleading. Instead, we continue to believe that the most appropriate way to assess whether an equity market is overvalued is to analyse the market based on a wide-range of different fundamental factors, such as dividend yield and earnings growth. However, we do acknowledge that behavioural factors within markets do exist and that some market participants do place significant emphasis on indices reaching particular milestones. We believe this may lead to some erratic short-term price behaviour during such times.

If not equities, where?

Given the strong performance of equities since the start of the year it is perhaps appropriate to re-examine whether this has materially impacted the relative value of this asset class against other potential investments. An analysis of the yield gap between global equities and gilts (bonds issued by the UK government) implies that, despite their strong recent performance, global equities continue to trade cheaply relative to UK gilts, based on long-term historical averages. This is a theme which, in the case of global equities, is mirrored against a number of different asset classes, including other “growth” assets such as UK property.

Conclusion

The news of equity indices hitting all-time highs is largely symbolic in nature, and we do not believe that investors should use this as a gauge as to whether a market is overvalued. Instead, we believe that investors should place a greater focus on understanding the fundamental factors driving equity market returns. Any decision coming from this, which may lead to a reduction in an existing equity allocation, must also be taken in the context of what other investment opportunities are available within the market and the risk/return objectives of an individual pension scheme.

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