FINANCIAL TIMES

January 2, 2012 4:01 pm

Time for a change of sentiment on equities

By Tony Jackson

While predictions are hazardous in these murky times, there is one I can make with reasonable confidence. At some point – no saying when – there will be a change of sentiment towards equities.

Not necessarily a rise in price, though that might be part of it. Rather, I expect a working through of that revulsion which – in the developed world at any rate – has turned equities into a pariah class.

This has reached an extraordinary pitch. It is one thing for the equity weighting of UK and European pension funds to have slumped from 50 per cent to 30 per cent in the past three years, according to Merrill Lynch. Partly, that will reflect falling market values. But, when we hear that quoted insurance companies have slashed their weighting from 20 per cent to 6 per cent, something else is wrong.

One factor is enemy action from regulators who are penalising long-term investors for holding long-term assets. But that mainly shows regulators to be as susceptible to prevailing sentiment as the rest of us.

The latest phase of revulsion extends to return on equity as a management objective. Andrew Smithers of Smithers & Co says it has had “a damaging effect on the economy”. Andrew Haldane of the Bank of England says bankers should instead be rewarded according to return on assets.

Each of those propositions is symptomatic, though not necessarily wrong. It is certainly striking that between 1990 and 2007, according to Mr Haldane, chief executive pay at the seven largest US banks rose tenfold – in line with return on equity. Had it been in line with return on assets, the figure would have been just 21 per cent.

And of course, this encouraged high leverage and risky behaviour. Indeed, given the increased reliance on bonuses rather than base salary, it also

encouraged volatility, since bonuses tend to go up more in a good year than down in a bad one.

It may also be true, as Mr Smithers argues, that today's reluctance by US corporations to hire or engage in capital spending reflects a harmful obsession with return on equity. It is apparently without precedent that from 2007 to 2010, US corporate margins rose sharply while the US economy shrank.

But this behaviour is not necessarily a criticism of equity as a class, or of return on equity as a concept. Rather, it reminds us that managers, like investors, are prisoners of context.

In the 1970s, when the US stock market was in the doldrums, managers concentrated on building conglomerate empires. That way they could reward themselves by company size in the absence of stock performance.

And in the 1990s, when the market was soaring, they converted to the gospel of shareholder value. This meant managing the company so as to deliver pleasant surprises, and drive the stock up even further.

But when all those antics are allowed for, we should remind ourselves of certain constants. Investors, for instance, have turned in droves from equities to bonds. But in balance sheet terms, corporate bonds are one hand clapping.

A large part of their value is derived from the absence of risk – which equity is there to absorb. So if equity falls too far, the value of the company's bonds also starts to be hit in proportion.

As for return on equity, it is an essential component of capitalism. Milton Friedman has been derided for his claim that the sole social responsibility of a corporation is to make a profit. And indeed, that is one of those simplified models beloved of economists that bear little relation to real life.

But it does contain an awkward truth. If the directors of a public company are not there to increase the owners' investment, it is hard to know why they are there at all. And if they are instead allowed to feather their nests and jeopardise the company, that is ultimately the owners' fault.

So what will cause the turn in sentiment? A prolonged bull market might do it unaided – if, say, the euro gets sorted, China prospers and western governments get their finances miraculously under control.

Failing that, it is partly down to the regulators, whose antagonism to equities is part of a worrying pattern of pro-cyclical behaviour. Or again failing that, one good burst of inflation might do the trick.

But in the end, it must be addressed of necessity. A sufficient stock of equity is essential to the western financial system, and today's stock was built up in happier times.

If it is not maintained, we will all be losers. In the long run, it is hard to believe investors and corporate managers could be foolish enough not to grasp the fact.

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