ARVEST

February 2011 | Issue No. 71

Investor Info

Investment Commentary

Economic growth and stock market performance

This investment commentary addresses the question of whether a high level of economic growth also in fact means higher stock market gains, as many investors assume.

A bipolar world has been emerging anew in recent years. This does not, however, entail a new Cold War, where the world is divided into regions dominated by either centrally planned economies or market economies. Divisions in the recent past are rather about differences in growth rates: On the one side we have the developed industrial nations, which are hardly making any headway in economic terms and trumpet 2% GDP growth as a strong performance by their economies and policies. On the other side are the developing economies for which growth rates of under 5% represent an “economic catastrophe”.

More growth means more profit?

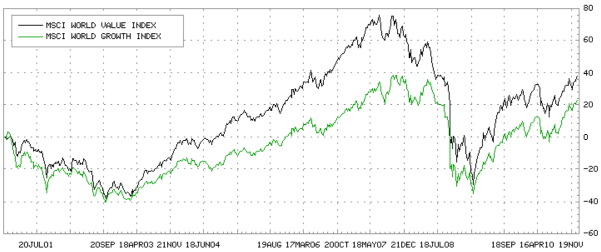
Institutional and private investors have increasingly shifted their investments towards the developing economies, due to the higher growth rates. The fundamental conviction behind this shift in investment strategy is quickly understandable at first glance. Intuitively, the majority of investors assume that economies with a higher growth rate must also generate higher stock market gains. Besides, the same fundamental convictions can also be recognized in the dialog between value and growth investors at the individual stock level. Which strategy brings the higher return? Investment in companies that have been generating good profits and distributing substantial dividends for years, or in companies that are growing, tend not to generate any significant profits and also not to distribute any dividends, but promise these in the future?

What does science have to say?

Numerous studies have grappled with precisely this topic. Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School carried out a study that was recently published in the Global Investment Returns Yearbook 2010[1] of Credit Suisse. The study is based on data of 83 countries over the past 110 years. The authors come to the

[1] Download under: http://tinyurl.com/DMS2010

conclusion, no doubt surprising for some investors, that investment in growth countries did not result in higher returns viewed over the long term.



Graph: MCSI World Value (black) versus MSCI Growth Index (green) over 10 years.

Mark Hulbert of MarketWatch gets to the heart of this intuitively unexpected result with a question and answer game:

Question: True or false? The stock market performs better when corporate earnings are growing more quickly. **Answer**: Believe it or not, the correct answer is false.

But that is not all. The above-mentioned study also comes to the conclusion that there is in fact a negative correlation between economic growth adjusted for inflation and stock market return over the long term. The result can however be different over shorter time periods.

Value style versus growth regions?

These results confirm my convictions on this subject. Yet how do they reconcile with the fact that our in-house funds, “ARVEST Global Stars” and “ARVEST Eurasia Stars”, have heavily invested in Asia, namely a region with high growth rates, although the ARVEST Investment Committee attaches great importance to a quality approach in making investments? Quite simply in that it is still possible to make targeted investments in value stocks in growth regions as part of an active investment strategy. Doing so requires a selection process that places the focus on those companies that are deemed to be solid under strict quality criteria and are also not overvalued. Directing a portfolio solely towards regions with growing economies, with no other differentiation, leads to risks that become particularly evident during hard times for the stock exchange. Investing therefore requires great caution, particularly with regard to passive investment strategies such as ETF, as such investment tools generally lead to investments in an overall market that is possibly already greatly overvalued.

Conclusion

The analysis in this investment commentary again highlights that investors do not make their investments on a purely rational basis. They are also persuaded by intuitive considerations, even if analyses over longer time periods contradict them. These findings about the supposedly rational Homo economicus, which have been confirmed regularly and scientifically in behavioral finance studies, must be incorporated in the analyses for asset management.

01.02.2011
ARVEST Funds AG,
Beyzade Han, Fund Manager