GRAY ISSUE

Can the level of interest rates be used to reliably predict investment returns?

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Local and global short-term interest rates are at low levels. This has led to questions about the rationale for holding cash both locally and offshore. We have addressed our cautious outlook for future equity returns in previous commentaries but what about the perceived low yield on the alternative?

Firstly, it is important to look at the real after-inflation interest rate, rather than the quoted one, as investors want to be compensated for inflation. Locally, the real rate has been approximated 1% over the very long term, but has fluctuated widely around the average and has sometimes been negative, for example, in the 1970s and 1980s.

Interest rates and equity markets

There is a widely accepted belief that if the real interest rate is low investors should automatically have a high allocation to 'riskier assets', say equities. Indeed a comparison of the long-term returns from various asset classes bears this out, with equities outperforming cash significantly over the long term. However, for lengthy periods, this has not always been the case - typically when equities were expensive. For example, R100 invested in a US dollar bank account in July 2000 is worth more today than R100 invested in the World Index despite the very low level of US interest rates*.

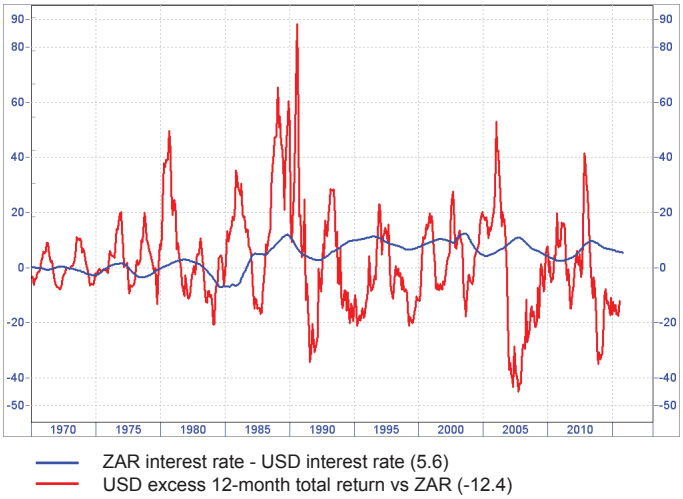
Table 1 shows different dates with the prevailing real interest rate in South Africa on that particular date and the subsequent five-year annualised real returns for the ALSI. On inspection it is clear that over this period the level of the real interest rate has been a poor predictor of future real equity returns.

Table 1 | Interest rates and subsequent ALSI real returns

Date	Short-term real interest rate (%)	Subsequent 5-year real total return for alsi (annualised, %)
31.03.1978	0.7	22.1
31.10.1980	-9.4	1.0
30.09.1984	10.6	11.5
31.08.1987	-7.0	-6.1
30.11.1993	1.1	0.9
31.08.1998	14.0	12.1
31.10.2002	0.0	25.6
30.04.2004	7.6	10.8
30.04.2011	1.4	?

Source: I-Net Bridge

Graph 1 | Interest rate differences can be a small part of total returns



Source: I-Net Bridge

Interest rates and investing offshore

Why would anyone hold any offshore cash if the interest rates in the developed world are below those locally?

The blue line in **Graph 1** shows the difference between SA and US interest rates. The red line shows the difference between the 12 month return achieved investing in dollar cash and the return from rand cash, accounting for the movement in the exchange rate, so that a negative point on the red line implies a loss from investing in dollar cash. The red line clearly dwarfs the blue line. For foreign cash, as is the case for stocks, the difference in prospective returns is more driven by purchase price than by short-term differences in income. Simply looking at the interest rate differentials today is therefore not a reliable predictor of future returns.

Value is determined by the price you pay

In our view, commonly accepted market wisdoms are not always true, even over horizons longer than the short term. This is certainly the case with the implications of low interest rates. What really matters is whether the asset you are investing in is cheap in absolute terms, not the real interest rate prevailing at the time.

*Ten years later R100 invested in a US bank deposit was worth R131 and in the World Index R127.

Commentary by Duncan Artus, portfolio manager, Allan Gray