HOW TO VALUE SHARES TO OUTPERFORM THE MARKET

A simple, new and effective approach to value investing

Glenn Martin
HOW TO VALUE SHARES AND OUTPERFORM THE MARKET
About the Author

After graduating from Wadham College, Oxford, Glenn Martin started a career in the City. Over 34 years he worked for a number of financial institutions. Having started in retail banking with Williams & Glyn’s, he subsequently worked in all banking sectors, including corporate, institutional, private and investment banking. For the latter part of his career he worked as Chief Information Officer for investment banks. In 2003 he was nominated for Best Personal Contribution in the Financial News Awards for IT Excellence in Investment Banking. In 2004 he won the Banking Technology Award for the Best IT Operational Achievement.

As a successful private investor, in 1994 Glenn developed a system for calculating the intrinsic value of the FTSE100 Index and of individual UK shares. When the System proved reliable, he established ShareMaestro Limited in 2006 to package and promote the System. ShareMaestro has received very positive reviews in the financial press.

After his family and investment, Glenn’s main interests are tennis, travel and drumming.
HOW TO VALUE SHARES AND OUTPERFORM THE MARKET

A SIMPLE, NEW AND EFFECTIVE APPROACH TO VALUE INVESTING

GLENN MARTIN
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The share valuation systems described in this book are based on ShareMaestro, which I launched commercially in 2007. Without the help of several key supporters, ShareMaestro would never have become available to private investors and this book would never have been written.

First I want to recognise the great work done by Zahir Virani, who turned what was a pretty crude spreadsheet into a great piece of software and who has managed subsequent enhancements very professionally. Next comes Dominic Picarda of the *Investors Chronicle*. Dominic has been a constant ally. He helped me tremendously with the validation of the share valuation system, always asks thought-provoking questions and has written some great articles on ShareMaestro for readers of the *IC*.

Tom Stevenson of *The Daily Telegraph* had the courage to headline and showcase ShareMaestro, then an unknown system, in the business section of *The Daily Telegraph*. It is extremely rare for articles on investment software to feature in the business pages of the broadsheets. Tom's article was both shrewd and positive; it sealed the launch of ShareMaestro.

Simon Griffin, although a professional chartist for *Shares Magazine*, liked the logical structure of ShareMaestro as soon as I explained it to him. He has also provided valuable assistance and advice in my efforts to get a low-cost ShareMaestro fund marketed by a fund management group.

When Dave Evans, of *What Really Profits* magazine, first contacted me to do an article on ShareMaestro, I tried to put him off because I thought *WRP* concentrated on short-term trading systems. However, Dave would not be deterred. In addition to producing some very good articles on ShareMaestro, Dave regularly suggests strategies to boost ShareMaestro returns. The use of moving averages as a key risk control for the FTSE100 high-risk strategies is down to Dave.
Annabel Watson is my model private investor. As well as acting as my guinea pig for new versions of ShareMaestro, she has put a lot of effort into the presentational side of the product. She is also a great source of inspiration.

My final acknowledgement is to my family, who provide constant encouragement and put up with my obsession to equip and motivate private investors to manage their own funds.

September 2011
Investment in equities and stock markets involves risk. Past performance is not necessarily a guide to future performance. Your specific needs, investment objectives and financial situation need to be taken into account before making investment decisions. You are strongly recommended to gain appropriate professional advice before acting on any information or valuations provided directly or indirectly by this book and to conduct your investment activity through an appropriately authorised company.

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The contents of this book, including the systems developed by the Author, are subject to copyright. These systems are restricted to personal use and may not be used in any way for commercial purposes. No part of this publication may be by any means reproduced or transmitted without the prior written permission of the publisher.
What this book covers

Buy low, sell high is an old investment adage. However, as a piece of investment advice it is useless. You cannot know, until it is too late, whether the price at which you bought will prove to be low or high. If you bought at what you thought was a low price, say 100, and the price subsequently fell to, say, 50, you can see with the glorious benefit of hindsight that the price you paid was too high. But by then it is too late. You have made a loss. To help you buy low, you need a system which identifies cheap prices.

The investment advice of this book is buy cheap, sell dear. I explain how you can calculate the real current value of the UK market and of individual shares. By comparing these values with the current market prices you can see whether the prices are cheap or dear and thus can decide whether or not to make an investment.

The principle of buying shares when they are cheap is known as value investing. I explain the most popular techniques that are used by investors to identify cheap shares and why I think these techniques are deficient. These deficiencies prompted me to develop my new valuation system, which calculates the current value of UK shares and the UK market. To prevent any confusion, I refer to this new valuation system as the System or my System throughout this book.

The System is different because, rather than using theoretical ratios and models to calculate the current value of a share, it calculates the current value of the two actual future sources of investment payback which the share investor should receive: the dividend stream and the sale price of the share. Uniquely the System takes into account not just relevant company-specific data but also
economic factors such as interest rates, inflation and growth. This book describes how to use my System and also provides a complete toolkit for creating personal wealth through UK equity investment. It gives:

- Step-by-step instructions for creating and using the System. All you need is a basic spreadsheet. The valuation methodology is similar to that used by ShareMaestro (www.sharemaestro.co.uk).
- Practical strategies and techniques for using the System to outperform the market
- Advice on how to double the market value of your long-term investments purely through avoiding high commercial fund-management charges
- Recommendations of the best service providers for all the services which you need to become a successful UK equity investor at minimum effort and cost
- Details of tax breaks which you can employ to minimise or eliminate the impact of tax on your investments
- Key risk controls which you should adopt to ensure that your accumulated wealth is not damaged by surprise events
- Essential checks which you should make before investing in any share

STRATEGIES WITH A MARKET-BEATING TRACK RECORD

The book includes two FTSE100 strategies which have substantially outperformed the market over the long term:

1. A medium-risk strategy. In the decade ending 31 December 2010, the medium-risk strategy produced over four times the return of a FTSE100 tracker fund. Based on the long-term real annual growth rates of this strategy since 1984, you could turn £10,000 into £115,168 in real terms over the next 40 years. And you would be exposed to less risk than from investing in a FTSE100 tracker.

2. A high-risk strategy. Over the same decade to the end of December 2010 the high-risk strategy outperformed every commercially managed UK equity fund on the market. Based again on the long-term real annual growth rates of this strategy since 1984, you could turn £10,000 into a staggering £2,242,344 in real terms over the next 40 years.
Comprehensive long-term track records for both of these strategies are provided.

I also describe how you could transform the income payable from a fund accumulated through long-term regular saving. The traditional approach is to invest annually in a commercially managed fund or funds and use the proceeds later in life to buy an annuity (for example, to provide a pension). I explain how you could get a much higher income from a lump sum than from purchasing an annuity. I show how you could use the FTSE100 medium-risk strategy in this book to build up a fund over 45 years to deliver an annual income nearly eight times larger than that provided by annuity purchased from the proceeds of a median-performance, commercially managed UK equity fund or funds.

TERMINOLOGY

VALUE

In the context of this book value has two meanings. The first concerns what something is worth, as distinct from its price. So a house may be valued at £500,000 but be put on the market for £530,000 – its value is £500,000 but its price is £530,000. The same thing happens with shares – they can trade at prices that are more or less than their value.

The second meaning is: market value. The current market value of a fund is calculated by valuing all the constituent holdings of the fund at the current market prices for each holding. If I do not use the phrase market value in the text then the first meaning of value is intended.

FUND

In the context of investment, a fund is a specific, separate pool of money. A commercially managed fund is one operated by a professional fund management firm, such as Fidelity. These firms offer a range of different funds in which investors can buy units. The different equity funds provided by these firms cover different markets and different types of company.

When I advocate that you should manage your own funds, I mean that you should manage your own money pools for investment. Your aim is to maximise the growth of your fund(s). According to the strategies which you follow from this book, your funds may include, for example, individual shares,
low-cost commercially managed FTSE100 funds and, sometimes, interest-bearing cash accounts.

**WHO THIS BOOK IS FOR**

This book is for anyone who wants a secure financial future – especially those who cannot rely on future earnings for a comfortable life – and for anyone who wants to take control of their own financial affairs. Entrusting your hard-earned savings to professional fund managers is a very expensive option.

To secure your financial future, you must be prepared to:

- invest up to ten minutes of your time every weekday and up to 30 minutes every weekend, if you want to use one of the FTSE100 strategies
- manage a portfolio of at least ten shares, to diversify risk, and devote on average up to two hours of effort per week, if you decide to invest in individual shares
- learn about the principles and practice of effective equity investment in order to become a better equity investor
- have an investment horizon of at least three years and not be easily panicked by short-term events
- accept some risk in exchange for the reasonable expectation of significantly higher reward.

**WHO THIS BOOK IS NOT FOR**

This book is not for:

- Those that believe that there is a silver bullet which will guarantee instant riches. These ‘guaranteed silver bullets’ do not exist.
- Those who trust tipsters or fund managers who, by the use of highly selective examples, give the impression that regular returns exceeding 30% p.a. can be easily obtained (for a fee!). The only professionals who abuse statistics as much as politicians are financial product salespeople. If an investment proposition sounds too good to be true, it almost certainly is too good to be true.
- Short-term traders who expect to make their fortunes in a few months. Virtually all non-professional short-term traders lose money.
• Those who want to buy shares in the hope that the company will be taken over or will realise greater value than the current market price through partial or total sales of its assets. **The system in this book does not value the assets of companies. In most cases valuing company assets is a highly subjective process and is prone to significant error.**

• Those who want to invest in shares which have no prospect of paying a dividend within the next five years. **My system uses the current and prospective dividends as the core of its valuation methodology. It cannot therefore value companies which are not expected to pay a dividend within the next five years. Furthermore, assessing the worth of such companies carries great risk.**

**HOW THIS BOOK IS STRUCTURED**

After the prologue, which explains the personal story of how I came to develop and market ShareMaestro, the book is divided into five parts and two appendices:

**PART I – CRITICAL INVESTMENT CHOICES**

Part I explains the case for investing in UK equities and why you should manage your own funds.

**PART II – INTRODUCTION TO VALUE INVESTING**

Part II explains what **value investing** is and the deficiencies of current approaches to value investing. I then describe the principles of the System and the superior long-term returns which you can expect from using the System effectively.

**PART III – THE NEW VALUATION SYSTEM**

Part III provides a step-by-step guide for you to create the FTSE100 valuation system using a basic spreadsheet. I also explain how you can use the System's FTSE100 valuations as buy and sell signals and I provide validation of these signals since the creation of the FTSE100 in 1984.

There then follows a step-by-step guide for creating a spreadsheet to value individual shares.
At the end of Part III, I look at how you can test the impact changing the input values of the System, either individually or in combination, has on valuations. This feature is very useful for constructing worst-case and best-case scenarios and for identifying one-way bets.

**PART IV – PUTTING THE SYSTEM INTO PRACTICE**

Part IV includes several powerful ways in which you can use the System to achieve superior investment returns. These include:

- a medium-risk, high-return FTSE100 strategy
- a high-risk, stellar return FTSE100 strategy
- a strategy for successfully running your own share portfolio
- Strategies for transforming your pension prospects
- decision tools for assessing specific investment products, including a comparison of FTSE100 investments with fixed-rate cash investment.

**PART V – INVESTMENT ESSENTIALS**

Part V covers essential requirements for successful equity investment, including:

- how to set your investment objectives and monitor progress
- how to take advantage of tax breaks
- recommended providers of the services which you will need
- key risk controls which you should employ to maximise the long-term real market value of your savings.

**APPENDICES**

- **Appendix 1**: Directory of websites which provide free relevant information for executing the strategies in this book.
- **Appendix 2**: Glossary of terms used in this book.
Investing is in my blood. My father was a very successful private investor and I started to read his copy of the Financial Times from an early age.

My experience has shown me that share investing is an essential component of successful personal financial planning. Today, because of the demise of final salary pension schemes, investing is a critical activity for most people who lack inherited wealth and wish to establish long-term financial security.

RESCUING A DERIVATIVES FIRM

In 1994, when I was working for a European bank, I was sent to rescue a European equity derivatives boutique which the bank had acquired. Equity derivatives are traded securities whose value is dependent on the price of an underlying share or share index. The local regulators were threatening to close the firm down because it had not submitted the regulatory returns on time and could not reconcile its trading profit with its accounting profit.

It was a fascinating and demanding experience. I got to work very closely with the traders and to understand how they made their money. I decided to study how the prices of equity derivatives are determined. Luckily the firm had a very strong training culture. There was a series of self-study tapes and text books which taught me the basics.

THE BLACK-SCHOLES FORMULA

The firm used a variation of the well-known, Nobel prize-winning Black-Scholes system for valuing derivatives. The Black-Scholes formula looks very
complicated at first glance, but when you break it down into its constituent parts it is quite logical. Among the factors used to value an equity call option are:

- the price of the underlying share
- the time to expiry of the option
- the strike price of the option (i.e. the price at which you are entitled to buy the share)
- the share dividend (to which the option-holder is not entitled)
- the risk-free interest rate
- the volatility of the share price.

I completed my assignment with the derivatives boutique and persuaded the regulator to withdraw their threat to close the business down. I was then inspired to research how I could produce a system for valuing cash equities, using the same kind of logical approach as is used in the Black-Scholes formula.

**A NEW VALUATION SYSTEM**

Following extensive research into the way the various elements of the equities market interact, I developed the System from first principles. I completed the System in 1995 and then monitored how it performed over the next few years.

This was a very interesting period for the UK equity market. In 1997 the new Labour government withdrew the ability for tax-free entities, such as pension funds, to reclaim the 20% tax credit on dividends. As much of the market consisted of such funds, in theory the market should have fallen by around 9% because of this development. This is because the dividend yield should have increased to make up for the loss of the tax credit. Leaving aside organic dividend increases, the only way for a dividend yield to increase is for the share price to fall.

However, the opposite happened. Share prices carried on rising. Apart from a sharp drop at the end of 1998, the FTSE100 continued to climb, fuelled by dot.com mania, and reached a peak of 6930 at the end of 1999. My system said that the market was worth **over 40% less** than this. I was beginning to lose confidence in my System.

And then the crash started. Over the next three and a quarter years, when reality set in, prices fell and fell until they reached a low of 3287 in March
2003. As is usual when panic begins, market prices fell too low. By this stage, my System said that the market was now worth over 50% more than the price at which it was trading.

Prices then surged. They reached my valuation in less than two years – a compound annual capital increase of 24%. I regained confidence in my System. Subsequently I have back-tested the System to get FTSE100 valuations for every single trading day since the start of the FTSE100 in 1984. This period incorporates both booms and busts, including dramatic one-day crashes such as Black Monday in 1987. The back-testing validated the System. You can see the summary results of the tests in Part III of this book.

In 2005 I retired from my last employed position, as Chief Information Officer for J.P. Morgan Cazenove in the City.

MAKING THE SYSTEM AVAILABLE TO PRIVATE INVESTORS

I have always strongly believed that private investors:

• should have part of their long-term investment portfolio in shares
• should manage their own share investments rather than suffer the high charges levied by the professionals.

With the major pension changes that were introduced in April 2006 – such as employees being given for the first time the same rights as self-employed persons to manage their own Self-Invested Personal Pensions (SIPPs) and to enjoy the associated tax benefits – I saw an opportunity for private investors to use the System which I had developed to get effective returns from both SIPP and non-SIPP portfolios.

By 2007 the System had been professionally packaged and was ready to go to market via a website which I had designed. I contacted Tom Stevenson of The Daily Telegraph to demonstrate the System to him. I had always respected his columns for their shrewd and incisive advice for personal investors. I visited Tom in the Telegraph’s new premises in Victoria Plaza – ironically the very same premises where I had worked as European Technology Head for the investment bank, Salomon Brothers.

Tom was impressed by the System, which I had branded ShareMaestro. I was very pleased when he said that he would write a feature on it for the Telegraph. I was delighted when I opened my Telegraph one morning to find that
ShareMaestro was headlined in the Business Section. Tom had written a great article, which included the memorable quote: ‘ShareMaestro ticks all the right boxes in my holy grail quest.’ ShareMaestro was born!

Since The Daily Telegraph article, ShareMaestro has received very favourable reviews in finance periodicals such as the Investors Chronicle, Shares Magazine and What Really Profits magazine. It also featured in David Stevenson’s book, Smarter Stock Picking, published by the Financial Times in November 2010.

THE VALUATION SYSTEM IN THIS BOOK

The system described in this book uses a very similar valuation methodology to that of ShareMaestro. Where there are differences, I point them out in the relevant sections of the book. The system will produce valuations which are very similar to those of ShareMaestro, except when you have chosen to use one of the alternative options which I provide for calculating a judgement-based input value (e.g. the risk premium for a share valuation).

You may ask, therefore, why I have written this book and revealed the valuation system behind ShareMaestro. There are three simple answers:

1. Although the valuation methodology is copyright, the valuation principles have never been secret. From the outset the ShareMaestro website has included a page entitled ‘How ShareMaestro Works’.

2. Providing more detail about the valuation methodology and its track record prevents ShareMaestro being treated as a black box system which demands blind faith from its users.

3. The latest version of ShareMaestro contains new time-saving features that are of enormous benefit to the serious private investor, above and beyond the valuation methodology itself. You will be perfectly able to produce accurate valuations to help with your investment decisions using the System in this book, but the enhanced features of ShareMaestro will save any serious investor a lot of time.

To read more about all the features of ShareMaestro please visit the ShareMaestro website (www.sharemaestro.co.uk).
The purpose of this book is to show how you can create personal wealth through effective long-term investing. To maximise investment growth, there are three critical requirements:

1. Invest where there is the greatest probability of achieving the best returns.
2. Ensure that your capital is not eroded by third-party management charges (i.e. manage your own investments).
3. Minimise or eliminate the impact of tax on your capital.

The first two requirements are covered in Part I. Ways to eliminate or minimise the impact of tax on your capital are covered in Part V, chapter 19.
ASSET SELECTION — CHOOSING EQUITIES
There is a wide variation in the returns achieved by different types of asset and so achieving the best investment performance relies on optimum asset selection. As an investor, you have a choice of various asset classes:

- cash (deposits in banks and building societies)
- government bonds
- corporate bonds
- equities
- index-linked investments
- commodities
- property
- alternative investments (such as art or fine wines)
- international investments.

The last four asset categories listed are outside the scope of this book, for the following reasons:

- **Commodities** are generally short-term and high-risk investments. Except for the companies listed on the London Stock Exchange where the main revenue comes from commodities (e.g. oil and mining companies), commodity investments are beyond the focus of this book.

- **Property** (residential and commercial). Except for the fabulously wealthy, the main avenue for direct property investment for the private investor has been buy-to-let property financed by a mortgage. Certainly buy-to-let property has been a very successful investment for some private investors. It has also been a very bad investment for others. This is a field
which requires much specialist expertise and, in the management of the properties, a much greater investment of time than is envisaged by this book for running an equity portfolio.

- **Alternative investments.** Again this is a field which requires a high degree of specialist knowledge for successful investment.

- **International investments** carry an extra layer of risk in the form of currency risk. Adverse movements of the asset currency against the pound sterling could erode or even eliminate any gains made in the currency asset value. For this reason, we do not look at these assets here.

THE OUTPERFORMANCE OF OTHER ASSETS BY EQUITIES

That leaves the first five categories of investment in the list – cash, government bonds, corporate bonds, equities and index-linked products. For long-term investment, equities are much more likely to provide a better return than the other four options.

Investment in cash has the worst track record. Cash might have the superficial attraction of maintaining or increasing the nominal value of your capital (assuming the deposit-holding bank does not go bust and your deposit is not greater than the limit of the Financial Services Authority (FSA) compensation scheme). But maintaining the nominal value of your capital is a futile objective.

You are far more likely to increase the real value of your capital through effective long-term investment in equities than through investing long term in cash. For example, as shown in Table 1.1, over 50 years equities have produced over triple the annual real return of cash.

### Table 1.1 – Real UK asset returns from 1899 to end-2010 (% p.a.)

<table>
<thead>
<tr>
<th></th>
<th>10 years</th>
<th>20 years</th>
<th>50 years</th>
<th>111 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equities</td>
<td>0.6</td>
<td>6</td>
<td>5.4</td>
<td>5.1</td>
</tr>
<tr>
<td>Gilts</td>
<td>2.4</td>
<td>5.8</td>
<td>2.5</td>
<td>1.2</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>2.1</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Index-linked</td>
<td>2.1</td>
<td>4.3</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Cash</td>
<td>1.1</td>
<td>2.6</td>
<td>1.7</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Barclays Capital 2011 Equity Gilt Study
Cash does play a part in the investment strategies covered in this book – but only at times when the System shows that equity prices are too expensive (and therefore quite likely to fall).

Government bonds and corporate bonds fare better than cash – Table 1.1 shows that over 50 years gilts returned 2.5% annually – but have not historically provided such high long-term returns as equities.

INDEX-LINKED INVESTMENTS

If available, you could buy index-linked gilts or national savings certificates for holding to redemption. However, they would be unlikely to give a return more than 2% above the rate of inflation (as measured by the Retail Price Index (RPI)). And even that may not be entirely risk-free for you. This is because there are large variations in price increases among the many components which make up the RPI; your personal inflation rate might be a lot higher than that quoted by the RPI. This means that even if your investments in index-linked gilts do earn 2% above the rate of inflation, the spending power of your money may still be decreasing. Therefore, we need to target a higher return than index-linked products can offer.

If you buy index-linked gilts in the secondary market (after they have been issued) you suffer the further risk that the traded prices may fall as a result of rising interest rates. At the end of 2010, the benchmark UK interest rate (Base Rate) was at an all-time low. This has inflated the prices of gilts (both standard and index-linked) and has enhanced the returns for these assets. These returns are likely to fall when interest rates rise.

These low returns and added risk mean that index-linked gilts are not suited to building the long-term financial security we are seeking.

THE REASON FOR EQUITY OUTPERFORMANCE

Why have equities been such a good long-term investment? The short answer is that managers and directors are incentivised to produce real growth in their companies. Many participate in long-term share or share option schemes and directly benefit when the share price of the company increases as a result of organic growth.

Increasingly all employees of companies are being given the opportunity to participate in such schemes. One of the prime ways in which humankind
obtains personal satisfaction and esteem is to introduce beneficial change. That is one of the factors which leads to the workaholic – where the employee gets more satisfaction from his corporate role than from his personal life.

Furthermore, the UK is an entrepreneurial nation, which once ran a world empire despite the relatively small population. I expect this entrepreneurial spirit to continue to drive real UK share prices higher in the future, providing high taxes do not suffocate all enterprise.

By contrast, governments, banks and companies will pay as little interest as they can on funds which they need to raise, providing they can raise the funds. Consequently there is no embedded reason for the real value of cash and bonds to increase over the long term.

The past long-term returns which I give for strategies using the System cannot be guaranteed for the future but I believe that human enterprise will continue to increase the real value of equities over the long term. So even a passive investment in a FTSE100 or FTSE250 ETF (exchange-traded fund), with dividends reinvested, should over the long term provide much better real returns than cash or bonds. However, the ability of the System to identify underpriced market and share opportunities should enable you to achieve considerably better results than a passive strategy.