



# Fisher Funds

## Investor Education Centre

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### Why do shares beat bonds?

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One of the first things I learned in my finance course at University is that over long periods of time, shares outperform bonds.

Recently commentators have suggested that the rule should be restated as “shares *usually* outperform bonds” because the credit crisis has led to bonds outperforming shares over the last few years. Whatever, it is still interesting to consider why shares have generally performed better than bonds. The simple explanation is that shares are riskier than bonds, so investors expect higher returns as compensation for taking a higher risk.

This risk-return trade-off is known as “the equity risk premium”. This is the excess return that an individual share provides over and above the risk-free rate (which is the interest rate on longer-term government bonds). If the return on a share is 15% and the risk-free rate over the same period is 7%, the equity risk premium would be 8% for this stock over that period of time.

So why are shares more risky than bonds?

A bond is essentially a loan, with the investor receiving a fixed return and the promise of their original money back after a certain period. A share is an ownership stake in a company that entitles the shareholder to a share of the earnings that might occur.

Shares have historically delivered higher returns than bonds because there is a greater risk that, if a company fails, all of the shareholders’ investment will be lost. But on the flip side, the potential return to shareholders could dwarf what they could earn investing in bonds.

As a simplified example, imagine you are starting up a business. It will take \$2,000 to set up and you only have \$1,000 so you borrow the other \$1,000 from a friend, promising to pay \$100 per year for the next 10 years, at which time you will repay the original \$1,000 loan. The first year, after all expenses, you find that your business has earned \$500. You pay your friend \$100 as promised, and you keep \$400. Your friend has earned 10% ( $100/1000$ ), but you have earned 40% ( $400/1000$ ) on your investment.

The next year does not go as well, and after expenses you find that the business has only earned \$100. You pay that \$100 to your friend, who again has experienced a 10% return. You on the other hand are left with a 0% return, though your two-year return is still around 20% per annum. And so it goes. With each year, you have the opportunity to earn more or less than the friend who loaned you money.

If your business proves wildly successful, your return will be exponentially higher than your friend's. If things fall apart, you may lose everything. As such, your position involves greater risk, but with the opportunity of greater return. If there was no possibility of greater return, there would be no reason for you to take the greater risk.

The outperformance of shares makes sense, as does investors’ choice to accept higher risk in order to get higher returns.

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