THE ITALIAN STOCK EXCHANGE FROM 1928 TO 2003

REPLY TO QUERIES RAISED BY A READER OF *LA REPUBBLICA*

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The reader's queries

Letter to Giuseppe Turani, editor of "Affari & Finanza"

The conclusions drawn [in the articles reviewing the Mediobanca Research Department survey] were that in the long run, investing in the Italian stock exchange is no guarantee against the ravages of inflation. Unfortunately, both studies have taken as their base dates years which are blatantly historically anomalous in terms of market performance, the first starting in 1960 and the second 1929 [in actual fact they are two sets of historical indices, one taking January 1928 as its base date, the other December 1960]. The troughs which followed these peaks were at least 50-60% below the initial values, possibly more; if these had been used as the basis for these surveys, the results would have been completely different. The only serious conclusion to be drawn from this data is that it is not a good idea to invest during a speculative bubble, but this is a lesson which most people can and have worked out for themselves. I find it hard to believe that an institution such as Mediobanca might use statistics in the way that the poet Trilussa illustrated by reference to chickens,[*] but that being the case, the question remains: what purpose do these surveys serve?

Mediobanca Research Department reply:

Let us begin by stating that the survey to which the reader is referring can be downloaded from our website at www.mbres.it, and we would recommend looking at it thoroughly to avoid jumping to ill-founded conclusions. The methodology employed is set out in full, and series of data are given on a year-by-year basis starting from 1928 and going right up to January 2003.

As a general reply to the criticisms concerning our choice of base dates and the implications for the Italian stock exchange, the reader can see for himself that only 24 out of the 77 readings for the deflated share price index are lower than the 18.7 recorded in January 2003. In other words, if he were to choose any year at random from those in the series, the chances of him finding one with a share price index lower than 18.7 are less than one in three. Considering that virtually all the more 'favourable' figures occur sequentially from 1973 onwards,

[*] Carlo Alberto Salustri, born in Rome in 1871 (d. 1950), wrote poems in the form of fables composed in Roman dialect under the pseudonym Trilussa. The reader here is alluding to one poem in particular, 'La statistica', where Trilussa explained that the kind of statistics published in his day suggested that everyone received one chicken a year even if an individual could not afford to purchase his/her own fowl during the twelve months, for if they could not do so someone else happily consumed it for them. See the final paragraph for our reply to this allusion.

accusations of mischief in our choice of a base date for a study which covers a time-span as long as this are swiftly dealt with.

Let us look at the specific issues more closely.

Why 1928?

Our survey only takes into account Mediobanca Research Department compilations of stock exchange indices. There are three of these historical indices, the earliest of which took 1928 as its base date, which is why our survey begins there. That particular index was published in the 1978 edition of *Indici e dati*, and we believe it is still a useful tool for those whose business is the Stock Exchange, not least because it involved reconstructing something like 40,000 listings and hence is not to be taken lightly. Perhaps this is why it has met with universal critical acclaim.

Why 1960?

Data based on straightforward prices can be very instructive if we assume investors simply spend the dividends they receive, but it is also interesting to see what happens if dividends are reinvested. The only series of retrospective data on dividends available to us which was comparable on a like-for-like basis started in 1960, which is why that year was given the base value of 100 in our total return index. However, for the purposes of clarity, it should be pointed out in response to the reader's final query as to the usefulness of our survey that the base date is actually of very little significance if it is considered that we also published separate figures for each individual year, which everyone is free to consult and interpret however they see fit. As far as we are aware, those who have reviewed our publication have not merely looked at the first and last years covered, but have also taken the trouble of attempting to illustrate the trends the data reflect in the light of their individual context. Some, such as Giuseppe Turani, even published the diagrams we constructed, as the reader can see for himself if he looks at our website.

1928 and 1960 are anomalous

As we all know, 1928 was a speculative bubble which burst the following year and was followed by a long depression. Looking at our data, the deflated share price index starts at 100 in 1928 and falls to just under 60 during the years of the Great Depression. If we had bought into the stock market at the lowest point of the depression, in a best case scenario we would have paid 56.4, only to find that in January 2003 we had a mere 18.7. This alone should be sufficient as a general answer to the question as to whether or not shares in Italy have offered protection against inflation. But at the risk of using sledgehammers to crack chestnuts, we might ask what would have happened if we had chosen an even earlier date as our starting-point. In his book *Cento anni di Borsa in Italia* (Bologna: Il Mulino, 2001), Giovanni Siciliano addresses some of the same issues we are looking at here but over an even longer period, from 1905 to 1995. He writes: 'Share prices in Italy fell by over 80% in real terms between 1905 and 1920, and have never recovered' (p.18). So if we had set our base date earlier than 1928, by January 2003 we would have had even less than 18.7.

So much for 1928, then, but 1960 cannot be said to be anomalous to the same extent. Indeed, it falls virtually in the middle of the so-called Italian 'economic miracle', at which point the stock exchange merely reflected the increasing value of Italian companies which were becoming more and more profitable. Nothing more logical than to invest in companies at a time such as this. Prices did fall thereafter, but not because of the bursting of some speculative bubble, but rather because of deflation in the part of the Italian economy made up by large firms, first because of nationalization (notably the electricity industry) and the setting up of state-controlled entities, then as a result of the oil crises.

Our task, then, was to prepare the figures diligently, while obviously remaining open to any suggestions as to how this might be improved. This is what the figures say; it is up to those who use them to explain the reasons underlying the trends which the data reflect.

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That said, we would like to put forward one interpretation ourselves, simply because we feel the only 'serious' conclusion the reader says he is able to draw from our study, that of not investing during a speculative bubble, is not perhaps quite so foregone as he seems to think it might be. The first reason for this is that no-one knows when a bubble has reached its peak and is likely to burst, nor when a deep recession is about to end. Second, our survey is intended to answer questions concerning investments over the long and very long term, questions which, for example, the U.S. stock exchange has answered in overwhelmingly positive fashion. Many books have been published on this subject, one of the best known of which is Jeremy Siegel's *Stocks for the Long Run* (McGraw-Hill, 1998). In this book, Siegel gives a diagram showing that the 'real' index of the U.S. stock exchange reached a high of just under 10,000 in the 1920s, falling to 558,945 in 1997, i.e. just before the recent bubble (rebasing the 1920s total as 100, the 1997 figure comes out as 5,590). It would have taken only around a decade for an 'imprudent' U.S. investor who bought in the mid-1920s bubble to be able to rest safe in the knowledge that he or his heirs could recoup the initial investment. This was not the case in Italy.

In our opinion, the figures show that the Italian stock exchange has produced a positive return over the long run only for those who invested when the economy was in the doldrums, such as the 1970s, when no-one wanted to buy shares because of fears of imminent nationalization and because companies were making losses, or at the beginning of the 1990s, when company accounts once again began to dip into the red. But then investing in near-bankrupt firms is hardly a salutary experience, especially when it is considered that U.S. investors did not need to resort to such measures in order to safeguard their investments from inflation.

It is worth bearing in mind that while stocks go down as well as up, investors are looking for a return that will more than compensate them for the extra risk involved in holding equities. What the difference between these, the so-called 'risk premium', should be has been the subject of numerous and complex disquisitions for many years now. These need not concern us here, except to say that current practice seems to suggest the premium should be 3-5% at least in order to provide adequate compensation for the risk taken. This being the case, would a hypothetically 'lucky' investor in the Italian stock exchange have had cause to rub his hands with glee? Let us take two dates covering a thirty-year span, the maximum possible, in order to compare total return indexes between countries., i.e. the investor buys at the end of 1969 and sells in December 2000. As the reader can see for himself, the Mediobanca index stood at 74.1 in 1969, virtually 26% below its base level, whereas in December 2000 it reached an absolute high for the entire series of 149.9. In other words, the scenario we are envisaging may also be described as somewhat 'anomalous'. However, even this translates to an annual average return of only 2.3%, which is insufficient to compensate our hypothetical investor for the risk he has taken. In modern parlance, we would have to say that despite producing positive returns, the Italian stock exchange has 'destroyed value'. The same calculation applied to non-Italian bourses yields much more satisfactory results, as Dimson, Marsh and Staunton's *Triumph of the*

Optimists: 101 Years of Global Investment Returns (Princeton University Press, 2002) shows. According to the authors, the U.K. stock exchange would have yielded an annual average return of 7.6%, the U.S. stock exchange 7.2% and the French/German/Swiss bourses 6-8%, with only Japan scraping in with a miserable 3.9%. Incidentally, Dimson, Marsh and Staunton suggest the return for the Italian stock exchange would have been 2.5%, a figure which is not significantly different from that produced by our survey despite being based on less representative historical indices.

The reader may therefore be reassured as to the trustworthiness of our data and as to how and why Mediobanca's Research Department compiles its publications. Our aim is simply to provide tools which are useful to the economic and financial community by producing data and indicators which have been compiled in diligent fashion and free of bias. The seriousness with which they are generally taken derives, we trust, from the rigour with which we produce them.

Lastly, the reference to Trilussa always raises a smile no matter how many times we hear it, but in this case it is misplaced. The poet is describing a situation which can be resolved simply by redistributing chickens more equitably. In the case of the Italian stock exchange, however, it would appear that there are very few chickens to go round.

Mediobanca Research Department