# Bracing for lower long-term equity returns

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# Bracing for lower long-term equity returns




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# Bracing for lower long-term equity returns

## Another double-digit decade is unlikely

Welcome to our first edition of The Equity Thematician, our new publication which will take a thematic approach in identifying equity market trends and investment opportunities. This first edition, which takes a look at 100+ years of US and global macro- and market data, will deliver some sobering thoughts about the return prospects for the next decade, the 2020s.

Don't get us wrong! Whilst this study of the structural drivers of long-term equity returns is very useful to put the current market situation in perspective, it should not be construed as an indication for our current 2019 tactical stance, which is still constructive, in particular on US equities. At the same time the study does shed some light on the currently generous equity valuations, which are unlikely so see a further expansion in this late phase of what might soon become the longest business cycle expansion in US history. During this expansion US equities have delivered around 12% geometric returns, 40% more than their long-term average! A reversal to that average would imply significantly lower returns for the 2020s, compared to those we have seen in the 2010s, as is recognized by many professional asset managers (see the table below)

### Structural drivers behind the reversal to lower returns

Averages alone, of course, provide little insight. Rather, the reversal to long-term average returns reflects the fact that positive trends cannot be sustained indefinitely. Moderating economic growth is the inevitable consequence of the reversion of a long-term demographic expansion, in particular in developed markets. And whilst there are concerns about continuing productivity growth, the decades' long bull run of collapsing interest (and inflation) rates is obviously over. Globalisation seems also to have touched a natural bound, whilst historically higher corporate debt levels reduce the scope for leverage as a further boost for equity returns. Lower equity returns might by themselves further feed into the reversal of these long-term structural drivers, as they will inevitably lead to (the necessity) of more savings, and hence less spending.

### Gearing up for rougher seas

For investors it will thus become harder to navigate the markets. On one hand, without equities multi-asset portfolios will have little mileage given that only the former are able to deliver returns that are truly correlated to economic growth. On the other hand, the need for more selectivity within the asset class, might once more shift the pendulum away from the pure index passive investors to those active asset managers who are able to capture the winning countries and sectors.

We hope you will find this report both insightful and enjoyable

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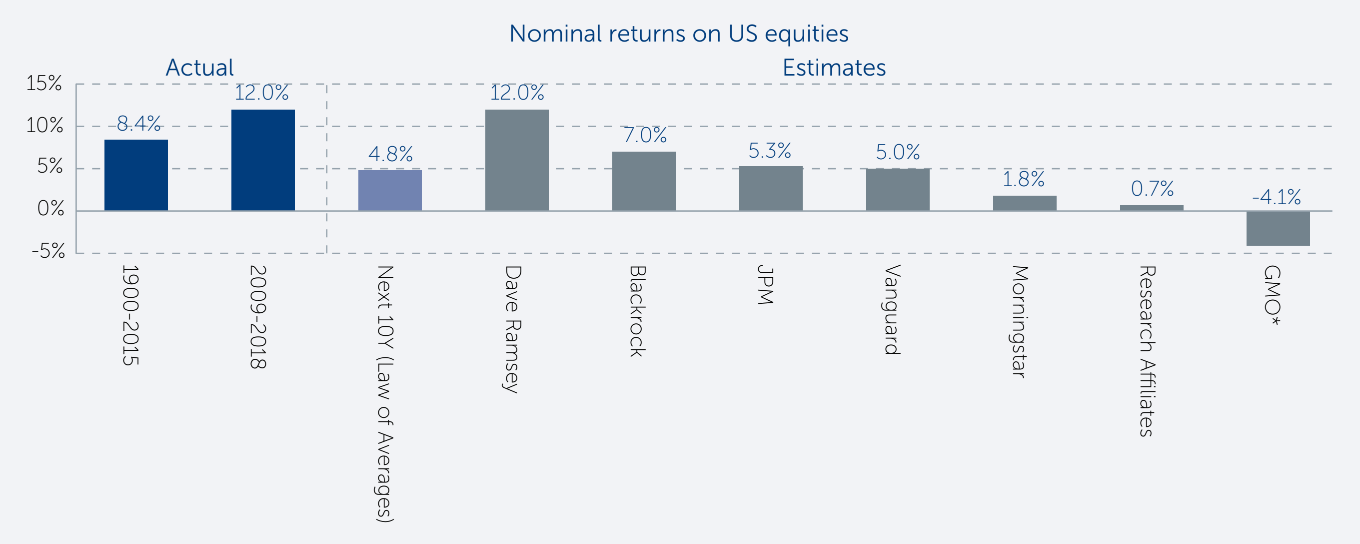
### Moderation of US equity returns is on the cards




Source: The Dimson-Marsh-Staunton Global Investment Returns Database, MSCI, Blackrock, JP Morgan Asset Management, Vanguard, Morningstar, Research Affiliates, Dave Ramsey, GMO, ADCB calculations

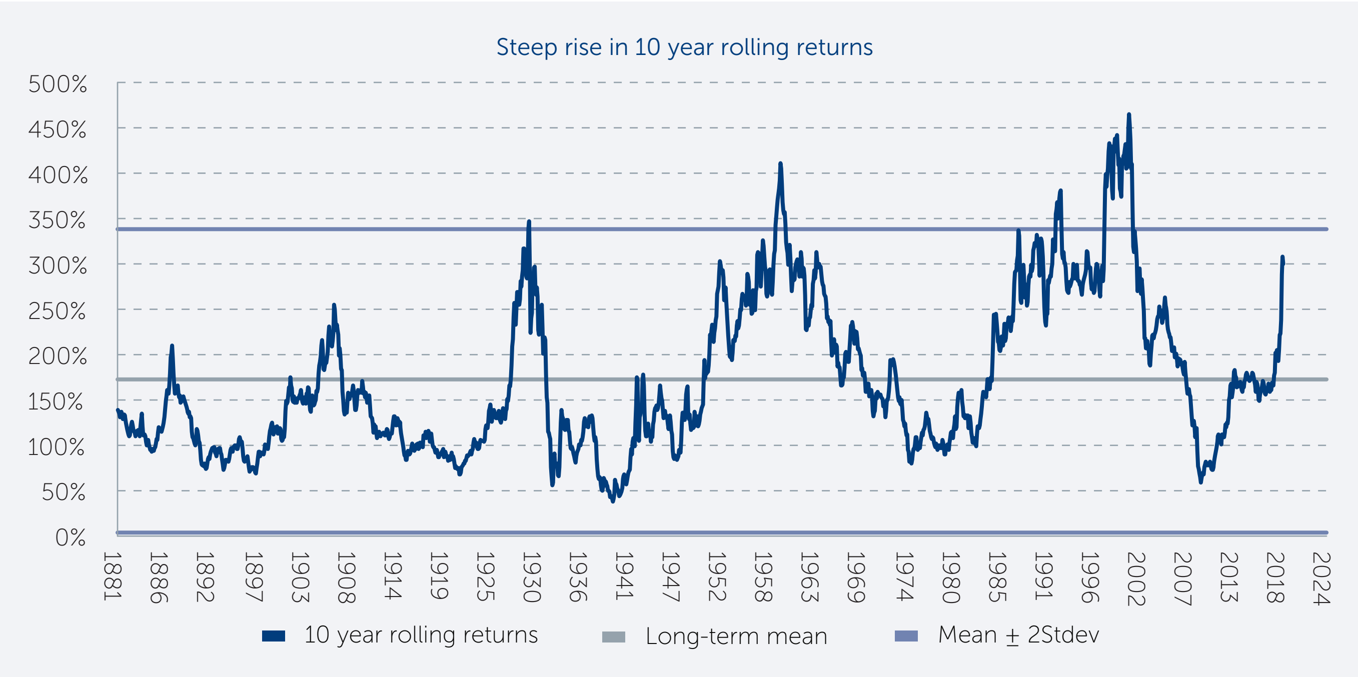
Notes: *real returns over next seven years

# Bracing for lower long-term equity returns

## Putting it into numbers: long-term equity returns

The point to start this discussion is by looking at the rolling ten year returns on equities. The chart below plots the rolling ten year returns on S&P composite index with the data going back to 1881. It can be seen that the returns over the past ten years have been pretty strong. Whilst there have been cases, albeit not many, in the past where the returns were higher than current, the speed at which these returns were attained now is rather unprecedented. Also, the ten years returns are now close to two standard deviations above the long-term average level and there is a good chance for them to revert to their long-term average. This tell us that the scope for equity returns to slow from now on is significant. Some of the analysis here (focussing on US) might be generalised for broader equities asset class not only because US makes up to 55% of the major equity benchmarks (for context, the next biggest weight is Japan with around 7.5% weight) but also because the US remains a reference market in all our discussions on equities.

**Current 10 year returns have been one of the fastest in the history**




Source: Robert Shiller Data (Published in the book, "Irrational Exuberance", Princeton University Press 2000)

> "The longer you can look back, the farther you can look forward."
>
> Winston Churchill

# Bracing for lower long-term equity returns

We also compare equity returns over the long run with those of other asset classes. The table below summarises risk-return parameters of global and US asset classes between 1900 and 2015. It can be noticed that not only the returns for equities have outrun those of other asset classes, but also the return-risk ratio is better for equities than that of bonds and cash. Granted, equities can be a lot more volatile in the short-term but in our view, the equity return profile is too good to ignore in the long-term.

So whilst we do expect equity returns to slow looking ahead, we do believe that global multi-asset portfolios cannot do well without equities. We would like to emphasise that our view is not that the equity markets will register losses but rather that those strong returns we saw over the past decades will be hard to come by in the near future.

This situation begs three questions – what, what and what? What is causing this slowdown in returns? What are the implications of lower return expectations? What is the antidote for this situation? In the following sections of this note, we address these points.

### Historical risk and return parameters (annual, real, 1900-2015)

| | Global Bonds | Global Equities | US Cash | US Bonds | US Equities |
|---|---|---|---|---|---|
| Geometric mean (%) | 1.8 | 5.0 | 0.8 | 2.0 | 6.4 |
| Arithmetic mean (%) | 2.4 | 6.5 | 1.0 | 2.5 | 8.3 |
| Standard deviation (% pt) | 11.3 | 17.5 | 4.6 | 10.4 | 20.1 |
| Min. Return (%) | -32 | -41.4 | -15.1 | -18.4 | -38.4 |
| Min. Return year | 1919 | 2008 | 1946 | 1917 | 1931 |
| Max. Return (%) | 46.7 | 68.0 | 20.0 | 35.1 | 56.2 |
| Max. Return year | 1933 | 1933 | 1921 | 1982 | 1933 |

Source: The Dimson-Marsh-Staunton Global Investment Returns Database

## Reasons to fear a long-term slowdown in returns

For the sake of simplicity and for ease of understanding, we classify the drivers of equity returns into three broad categories: 1) Macro 2) Supply and 3) Demand. Of course, some of the drivers discussed below are likely to fall into more than one category but the purpose is to be more generic yet exhaustive.

### Macro

Under this category, we discuss the broader macroeconomic conditions and their bearing on the stock market returns. Very broadly, equities are more geared to broader economic conditions than other asset classes and therefore, various long-term drivers of economies are also expected to have a strong bearing on equity returns.

### Demographics

Demographic dividends have long been touted as the drivers of economies and equity markets. While it is quite difficult to quantify overall demographic support, one indicator – which we call the demographic support ratio, calculated as the ratio of population between 25 and 64 to the rest – seems to help in understanding the overall demographic profile of a country. Intuitively, one would expect the population aged between 25 and 64 to provide support to an economy in terms of its contribution to the work force, income, productivity, consumption and investment propensity, among other factors, while the population outside this age group is largely dependent and cannot contribute to those factors. Therefore, the larger the share of population aged between 25 and 64, the greater the demographic support for the economy.

Demographics also impact equity market prices (or valuations) in several different ways. However the most straightforward link between equity prices and demographics is through demand. More specifically, the demand for equities tends to be higher in the age group of 30-50, the middle-aged working population that has the propensity and risk appetite to invest in equities. Stefano DellaVigna and Joshua Pollet in their research paper[1] find that demand growth forecasts based on demographics predicts industry profitability (RoE). Based on their model, the authors note that one additional percentage point of annualised demand growth due to demographics predicts a 5 to 10 percentage point increase in annual abnormal industry stock returns. A trading strategy exploiting demographic information earns an annualised risk-adjusted return of 5% to 7%. A paper[2] by Andrew Ang and Angela Maddaloni presents strong empirical evidence that demographic changes predict future excess returns in international data. Steven Bergantino's paper[3] discusses the impact of shift in demographics on the asset prices. The analysis finds that demographically driven changes in the demand for financial assets can account for approximately 77% of the observed annual increase in real stock prices between 1986 and 1997 in the US. A Federal Reserve Bank of San Francisco paper[4] authored by Zheng Liu and Mark Spiegel finds that demographics are able to explain a significant portion of changes in equity market valuations in the US.

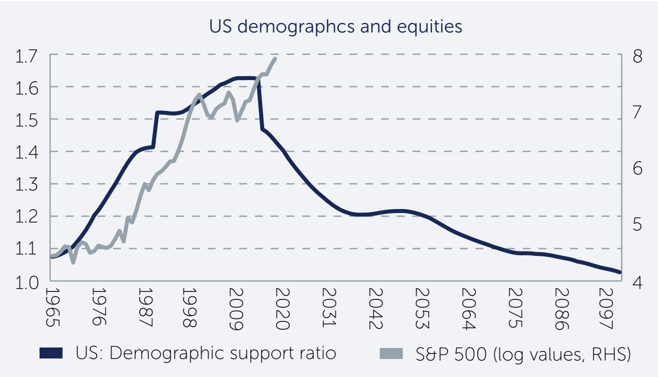

1. Attention, Demographics, and the stock market, Stefano DellaVigna and Joshua M. Pollet, National Bureau of Economic Research, March 2005
2. Do demographic changes affect risk premiums? Evidence from international data, European Central Bank, Working paper no. 208, January 2003
3. Life cycle investment behaviour, demographics and asset prices, Massachusetts Institute of Technology, September 1998
4. Boomer Retirement: Headwinds for US Equity Markets?, Zheng Liu and Mark Spiegel, Federal Reserve Bank of San Francisco Economic news letter, August 2011

# Bracing for lower long-term equity returns

The charts below make the point that the better the demographic profile, the better the equity returns. Evidently, strength from the demographic support is likely to fade in the Developed markets (DM) broadly. 2019 will be the first year in which the baby boomers are expected to be outnumbered by the millennials. As we will discuss in section 3, there are reasons to believe that millennials will not be as eager to buy equities as like baby-boomers were in their prime age.

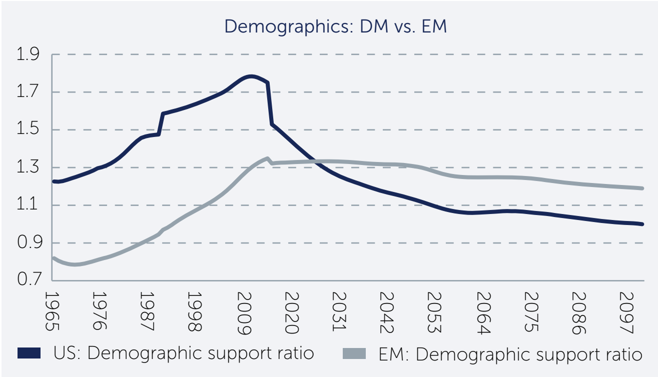
In this context, it is worth noting that the long-term trends in Emerging markets (EM) are more supportive than those in DM.

### Demographic support for US is fading[5]




Source: United Nations, Department of Economic and Social Affairs, Population Division (2017). World Population Prospects: The 2017 Revision and Robert Shiller Data (Published in the book, "Irrational Exuberance", Princeton University Press 2000).

### EM better positioned than DM[6]




Source: United Nations, Department of Economic and Social Affairs, Population Division (2017). World Population Prospects: The 2017 Revision

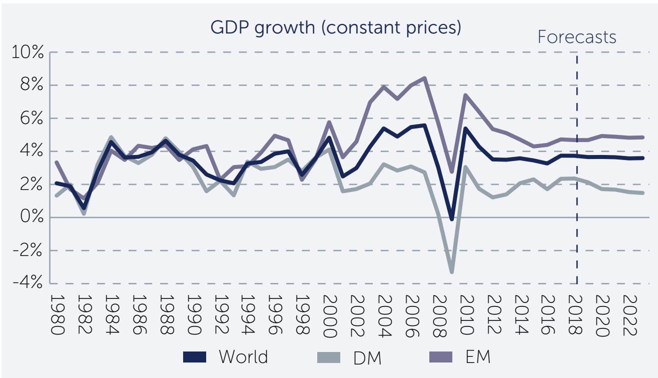
5. Notes: Demographic support ratio is defined as number of people in the age group of 25-64/ total number of people in the age groups of 0-24 and above 65.
6. DM comprise Europe, Northern America, Australia/New Zealand and Japan. EM comprise all regions of Africa, Asia (except Japan), Latin America and the Caribbean plus Melanesia (sub region of Oceania extending from New Guinea island in the southwestern Pacific Ocean to the Arafura Sea, and eastward to Fiji), Micronesia and Polynesia.

### Economic growth

There is a strong correlation between economic growth and the cash flow generation of corporates within the economy and this directly feeds into the equity prices. Of course, there are expected to be periods where the equity market cycle decouples from the economic cycle because of the "anticipation effects" for the market overall but in the long-run, the relation between economic growth and equity prices remains strong.

Global growth rates were generally higher until 2007. Following the 2008 global financial crisis, though there was a sharp recovery, such high growth rates were not achieved again. Further, IMF now expects global growth to moderate looking ahead. Fading demographic support, lower productivity growth and elevated debt levels have all played into this. All of these sub-factors are discussed in this note separately. With corporate earnings highly geared to economic growth and momentum, slowdown in the latter causes weakness in the former. For long-term equity investors, earnings growth is more important than valuations and therefore, earnings prospects should be closely monitored.

### GDP growth is expected to moderate looking ahead



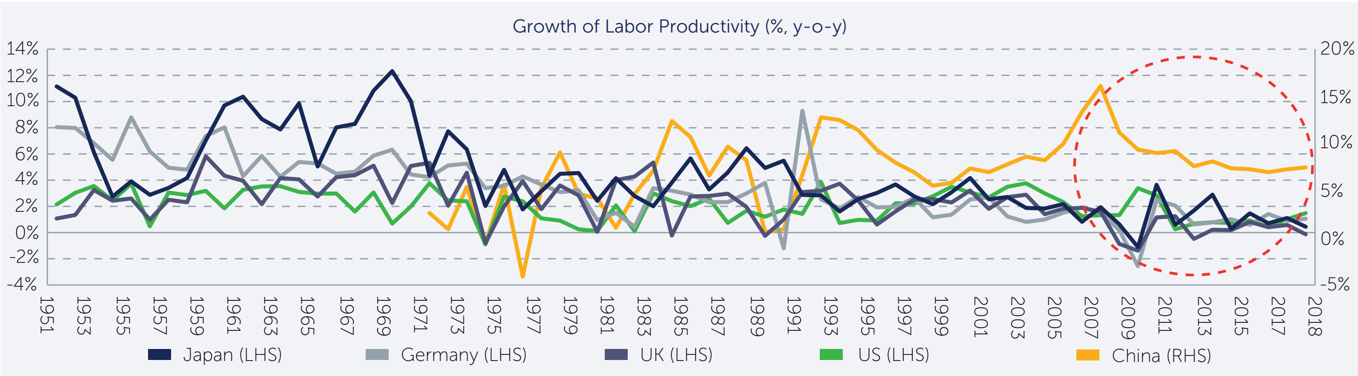

Source: International Monetary Fund, World Economic Outlook Database, October 2018

# Bracing for lower long-term equity returns

### Productivity growth

Strong productivity growth was the reason behind the rapid rise of living standards in the developed world over the past couple of centuries. However, weak productivity growth has been a post-Global Financial Crisis phenomenon and this has been attributed to a variety of factors. According to the OECD, the lack of adoption of new technologies is the primary reason behind slower growth in productivity. Other reasons mentioned include market distortions created by unconventional monetary stimulus. Capital misallocation arising from the fiscal policies are also often cited as yet another reason. Whatever the explanation, this phenomenon of slowing productivity that has already contributed to the 'secular stagnation' in the developed world, might also translate into slower economic growth looking ahead. Also, with productivity slowing, return on capital invested is likely to slow too and this should in turn result in lower equity returns looking ahead.

### Productivity growth has switched lower gear – a phenomenon observed across major world economies

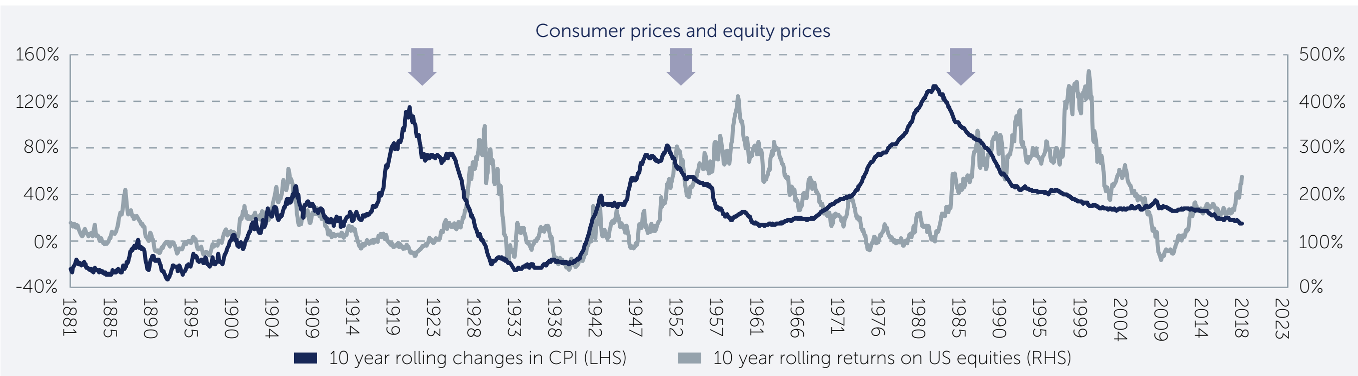



Source: The Conference Board Total Economy Database™ (Adjusted version), November 2018

### Inflation

Inflation and inflation expectations do impact equity market returns. As can be seen from the chart below, the periods where the consumer prices fall from the peak imply a strong equity performance because the monetary policy turns more supportive by then. Periods of rising inflation have not been good for equities. As can be seen from the chart below, consumer prices inflation has constantly edged lower over the past three decades and during this period we have seen some stellar returns from equity markets. Looking ahead, we doubt if we can remain in a period of falling inflation for too long. The employment picture – especially in the US – remains strong but so far has not resulted in substantial wage growth. However, this could change should the Philipp curve come back to life. Also, the rise of populist instincts across the world means an easier fiscal policy which could then very quickly translate into a pick-up in inflation. Of course, we are not foreseeing runaway inflation in the years ahead, but our point is rather that the disinflation environment that we have seen over the last three decades might not be sustainable.

### Periods of falling consumer prices have seen strong gains in equity prices



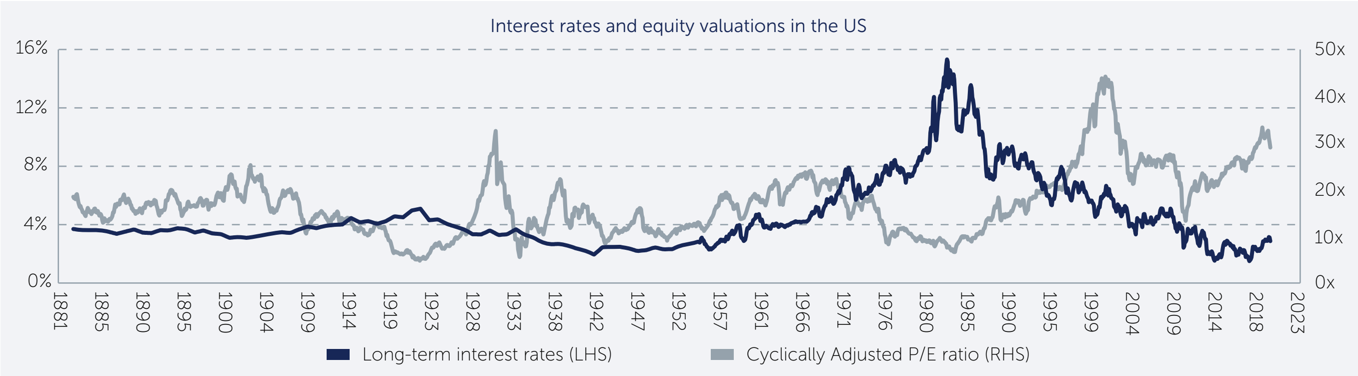

Source: Robert Shiller Data (Published in the book, "Irrational Exuberance", Princeton University Press 2000)

# Bracing for lower long-term equity returns

### Interest rates

Long-term interest rates have had a negative correlation to equity valuations. Periods of higher interest rates imply higher cost of equity and thereby lower valuations and vice-versa. As can be seen from the chart below, the long-term interest rates in the US currently stand at a low point compared with history. In fact, the current levels are not far from historical lows. Looking ahead, should inflation expectations rise (as discussed above), long-term interest rates should follow suite. As the next chart shows, in such an environment, it will be difficult for the equity market valuations to rerate – at least in the same way they have done over the past few decades.

### Equity valuations are sensitive to movements in the interest rate

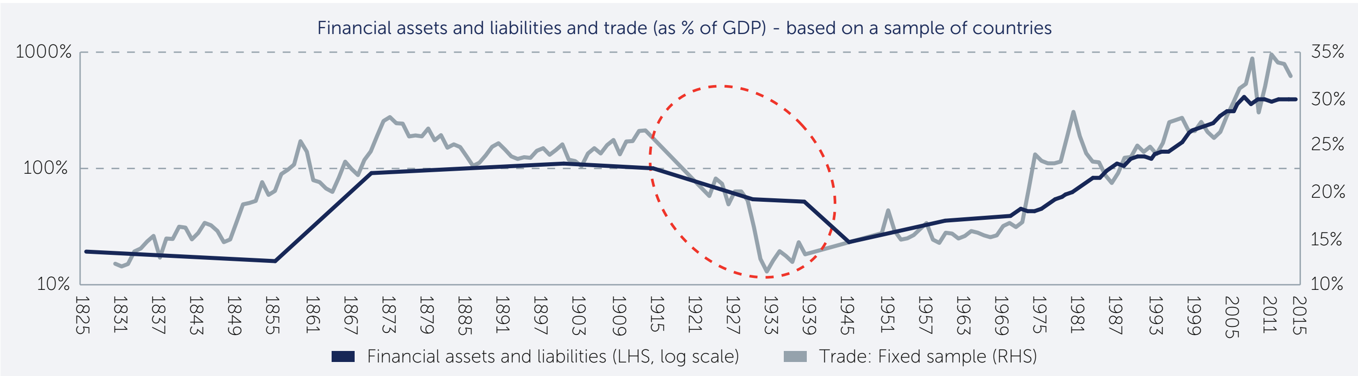



Source: Robert Shiller Data (Published in the book, "Irrational Exuberance", Princeton University Press 2000)

### Globalisation

Trade openness in the past has not only brought new products to new markets, it also resulted in lower costs of manufacturing. This has also been facilitated by a global trend of reduction in capital controls and a steady rise in migration. Now with the rise of protectionism challenging free trade and with economies becoming less open, benefits of globalisation enjoyed in the recent past decades might well reverse. This will have profound implications for economies, corporates and investors. For anyone who would argue that globalisation cannot be reversed, we would simply highlight that the first wave of globalisation died out with World War 1 and the Great depression and it was not until after the end of the World War II that the anti-globalisation movement showed signs of abating (BIS Annual Economic Report 2016/17).

### Globalisation is not irreversible




Sources: Federico and Tena-Junguito (2017); Lane and Milesi-Ferretti (2017); Obstfeld and Taylor (2004); Federal Reserve flow of funds accounts; IMF, Balance of Payments Statistics; World Bank; US Department of the Treasury; McKinsey Global Institute analysis; BIS calculations.

# Bracing for lower long-term equity returns

### The political economy of wealth and income (re-)distribution

Together with demographics, the secular reduction in interest rates, and globalisation, the redistribution away from wages to profits appears also to have been a structural driver of equity returns over the last 40 years. The stagnation in real wages, during decades of resilient and strong returns on equities, is now creating a political reaction that might well swing once more the pendulum in favor of wages at the expense of profits. Such reaction would fall under the same category of political upheavals, such as the rejection, by a growing part of the public opinion in developed markets, of globalism, whether that be free trade or immigration.

Measures aiming at shifting back income and wealth to workers, rather than owners, would politically be more akin to forms of socialism, or social democracy, rather than populism. They could, however, be as detrimental to global growth and global capital markets as measures that limit trade or immigration. In fact, in their paper titled "Origins of stock market fluctuations", Daniel L. Greenwald, Martin Lettau, Sydney C. Ludvigson argue that decisions around rewards reallocation between workers and shareholders have had a bigger bearing on equity market fluctuations in the long run than the changes in total productivity and shocks in risk aversion.

That this discussion is no longer merely academic is increasingly clear from the public political debate currently ongoing in the US. Senators Charles Schumer and Bernie Sanders are pushing legislation to stop companies from buying back their stock unless they satisfy a list of conditions to show that they treat their employees fairly, which they view as a way of favoring shareholders at the expense of all other stakeholders, including employees. Independently of the pressure that these political developments will exercise on companies aiming to buy back shares over the next year, the long-run implication of such legislation could be very harmful for equity markets since it would somehow tantamount to the government interfering in corporate decision making: who can better value if it makes sense to give money back to the shareholders than a company's management.

Increasing the taxes on the upper income brackets, or taxing overall wealth, as suggested by democratic politicians such as Elizabeth Warren and Alexandria Ocasio-Cortez (but also right wing Trump advisor Steve Bannon!), is perhaps a less disturbing policy. Having said so, if the findings by Greenwald, Lettau and Ludvigsons (see above) – are correct, such tax measures would nonetheless be detrimental to equity returns. Taxing income of the better payed compromises the incentive structure of company's senior and top management, whilst taxing wealth will reduce the demand for equity investments by the wealthier part of the population.

Of course, the timing and the effective impact of the political economy of re-distribution of national income back to the lower paid income segments of the population still have to be fully assessed. Like less favorable demographics and the pushback of globalisation, it represents nonetheless an additional potential long-term trend reversal, capable of biting in the sustainability of hitherto high equity returns.

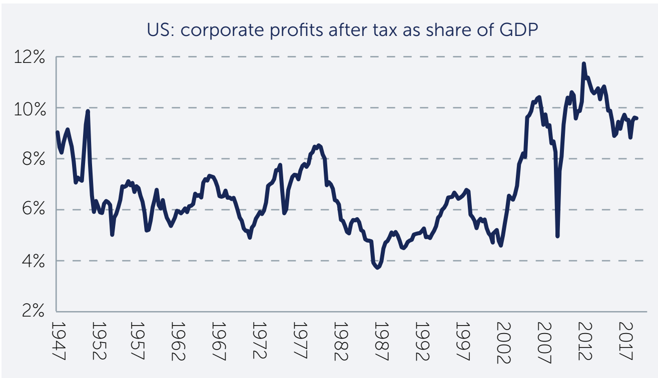
### Supply

Here, we discuss the supply side of equity instruments – both from the perspective of the market as well as the companies that list their shares in the market.

### Corporate profits

Some of the trends of the past three decades – globalisation, moderating inflation and falling interest rates have led to a strong rise in corporate profits. Especially, the supporting trends in globalisation – thanks to opening up of emerging markets like China and India – meant that costs could be cut with outsourcing. Now, if we believe that Globalisation trends are on decline, we risk seeing higher costs of operation and therefore lower corporate profits. Also, very broadly outsourcing might have run its course with few products/services remaining to be offshored, in our view. Therefore it is reasonable to expect the globalisation pendulum to swing to the other side (i.e. reshoring) resulting in lower profit margins.

### US corporate profits are relatively high in relation to GDP




Source: US Bureau of Economic Analysis

# Bracing for lower long-term equity returns

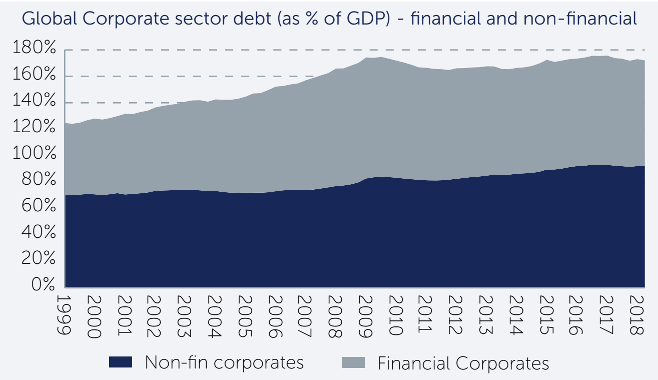
## Corporate leverage

Debt in the global corporate sector rose strongly over the past twenty years both in absolute terms as well as in relation to the GDP. However, the contribution of the financial and the non-financial sector has not been equal over that time frame. Between 1999 and 2008, the non-financial sector debt rose by 115% (to USD47.5trn) while financial sector debt increased by 168% (to USD58.3trn). After the global financial crisis of 2008, leverage in the financial sector remained flat but that of the non-financial sector rose by 58% (to USD74.9trn). As a share of GDP, the debt of financial sector is currently 79.8% (as at mid-2018) compared with that of the non-financial sector standing at 92.3%. Also, the rising levels of debt might have helped in improvement in the RoE in the recent past; but, with the levels of debt already elevated now, incremental leverage is likely to be perceived as a destabiliser than as RoE enhancer.

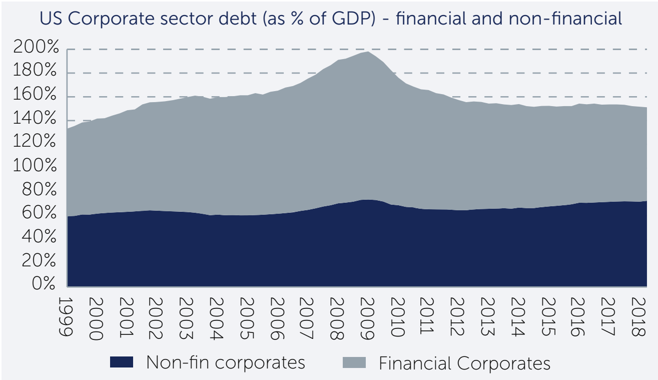
The US is no exception – the debt in the non-financial sector has risen to 72.5% of the GDP in 2018 from 59.4% in 1999. Whilst the non-financial sector did reduce its leverage following the global financial crisis of 2008/09(at the peak non-financial corporate sector debt in the US was 73.6% of GDP in early 2009), the recent years saw a pick up in the same. At over USD15trn in Q3 2018, non-financial corporate sector debt in the US is over USD1.5trn higher than it was in 2016. In the environment of moderating growth, given greater reliance on short-term debt, many US corporates might face rising refinancing risks for the next five years. About USD1.1trn of US non-financial corporate bonds will mature through 2020, with high-yield corporates accounting for over USD400bn of the total. However, some relief can be got from the fact that the financial sector has de-levered quite significantly since the global financial crisis.

Further, it could be argued that the US non-financial corporate sector had used much of this debt issuance to buy back equity shares over the past ten years. To that extent, the demand-supply dynamic in the equity market might have been affected. Whilst the maximisation of the shareholder value might have been a right strategy over the past years, we doubt if share buybacks can be sustained in a low growth environment looking ahead.

### Non-financial corporate debt has been rising across the globe… and the US is no exception




Source: IIF Global Debt Monitor (November 2018)




Source: IIF Global Debt Monitor (November 2018)

## Demand

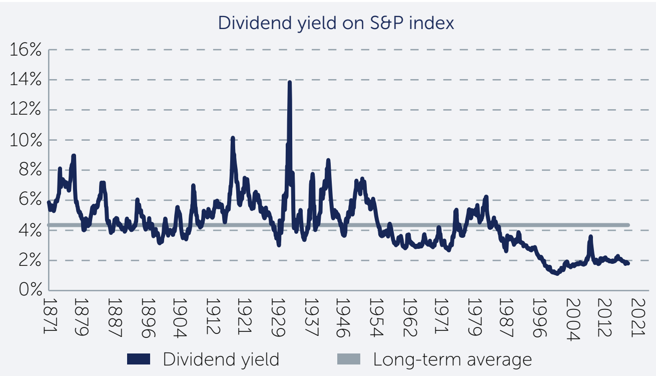
Here, we provide the context of the equity investors. In our view, the demand side of the equation is also likely to have a strong influence on the expected returns looking ahead.

# Bracing for lower long-term equity returns

### Valuations

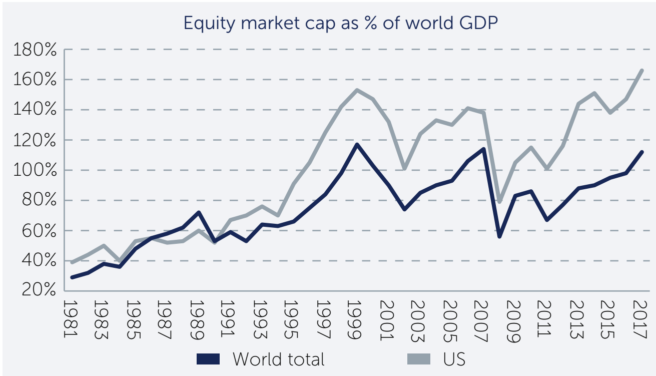
Cheap valuations have always provided a good entry point for long term investors. In our view, equity market valuations now are not as attractive given the late phase of the cycle. For instance, the dividend yield in the US is currently very low compared with historical average. Both for world equities and the US, market capitalisation as a share of GDP is at all-time high. Whilst these higher levels of valuations do not necessarily mean significant downside ahead, they do however act as higher grounds from which further substantial returns are hard to obtain. In this context, the US looks particularly overstretched, not only because of the rapid rise of the market capitalisation in relation to GDP in recent years, but also because of the extent of outperformance of US in relation to rest of the world.

**In the US, dividend yield is very low by historical standards**




Source: Robert Shiller Data (Published in the book, "Irrational Exuberance", Princeton University Press 2000)

**Market cap in relation to GDP has grown strongly across the globe with US outpacing the rest of the world**



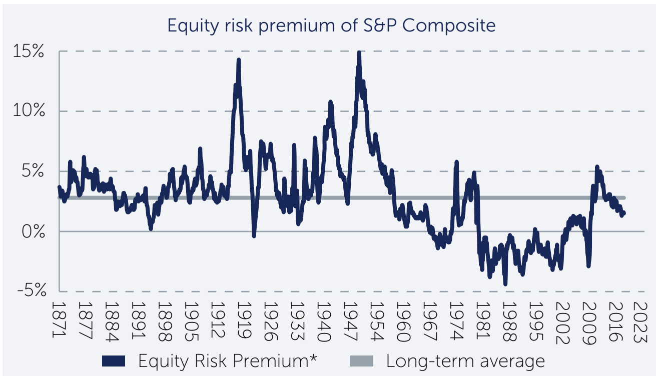

Source: World Bank

### Cost of equity

Over the past three decades, the realised equity risk premium has remained subdued relative to the long-term history. A range of factors might have contributed to this moderation of risk perceptions about the asset class over that period. The equity culture has been on the rise in many countries. Recent decades have seen retail investors warming up to equity markets and this has prompted them (and therefore all other market participants) to consider ways to lower their cost of investment. The rise of mutual funds meant that the average investors could obtain a diversified exposure to the broader asset class at a lower cost by taking advantage of the economies of scale in investing. The growth in index funds meant a reduction in investment fees and thereby further reduction in cost of investing.

Looking through purely cyclical lens, following 2010 which saw a significant jump, realised ERP has been moderating constantly. Current levels are below the long-term averages and well below the peak that have resulted in strong subsequent performance. In our view, investors who expect this low ERP environment to persist will be in for a disappointment in the medium term.

**US equities have benefitted from lower ERP over the past couple of decades**




Notes: *calculated as the difference between earnings yield and the long-term bond yield in the US | Source: Robert Shiller Data (Published in the book, "Irrational Exuberance", Princeton University Press 2000)

# What are the implications of lower return expectations?

### Pension funds face funding gap

According to the World Economic Forum, the world's six largest pension systems (US, UK, Japan, Netherlands, Canada and Australia) will have a joint shortfall[7] of USD224trn by 2050. The gap in those markets is the largest in the US, where a current shortfall of USD28trn is projected to rise to USD137trn by 2050.

Life expectancy has been rising as well. With the retirement age hardly changing in most economies, this longevity means that people are spending a longer time not working, without the savings to justify it. Indeed, as discussed in the demographics section of this report, the support ratios are fading. The population of retirees globally is expected to grow from 1.5bn in 2017 to 2.1bn in 2050, while the number of workers for each retiree is expected to halve from 8 to 4 over the same timeframe.

Whilst the unfunded pension liability is a real-economy problem (with governments, corporations and individuals the key players), the strain is likely to be further exacerbated when one takes into account the expectations of returns from equity investments as and when the funding happens. The compounding effect of funding gaps and relatively high expectations of future returns from equity investments are likely to result in disappointment.

For the funded portion of pensions, expectations from equity market will likely play a major role. And if the funds' assumed rate of investment return is not met, this is likely to induce further strain on public sector spending. It could very well be that if there's a sustained low-return market, the government contribution will eventually rise and crowd out some other public services.

### Retirement planners and wealth managers need to consider longer time frames

Lower return projections need to be incorporated when planning for wealth accumulation or for retirement. Lower returns could in one direction mean longer investment time frames – either starting investments at an early stage or extending the retirement age. Both will have policy implications in our view. In this context, a more proactive policy from Governments addressing these imbalances is warranted. However, any supportive fiscal stance should come in the back drop of elevated debt and rising interest rates.

### Save more, spend less – has economic implications

As the crowds start to factor in the potential for weaker returns ahead, they will be more inclined to save rather than to spend. This savings glut is likely to have negative implications for an economy like the US, where the personal consumption expenditure constitutes around 68% of the GDP, falling consumption trends are likely to have a defining impact. Any such trend is likely to only exacerbate the pain caused by the aging population. Amongst the millennial workers (defined as the population cohort born in 1980s and 1990s) in the US, 71% are already saving for the retirement with higher share investing conservatively in bonds, money market funds, cash or other stable investment[8] .

### Students' costs rise as endowment funds face lower gains

A lower return environment would mean the US university endowment funds face deficits in future funding requirements of colleges and universities and this would in turn mean higher student costs. The rise of student loans in the US has been hotly debated over the recent years not least because of the growing size of its stock and broader implications. At USD1.5trn, student loans debt stock has surpassed American's credit-card and car loan stocks. As per the Fed[9] the rising student loans has constrained the home buying capacity in the US.

### Asset managers have to find innovative ways to increase margins

Lower returns, along with the already vigorous competition are likely to force asset managers to search for efficiency gains. A latest research paper from Accenture consulting identifies – outsourcing, robotics, processes streamlining and technology rationalisation as some ways to go about managing costs. In fact, the underperformance of the active money managers in the recent years might have swung too much to one side and might swing in the opposite direction soon, as we embrace a period of lower equity returns.

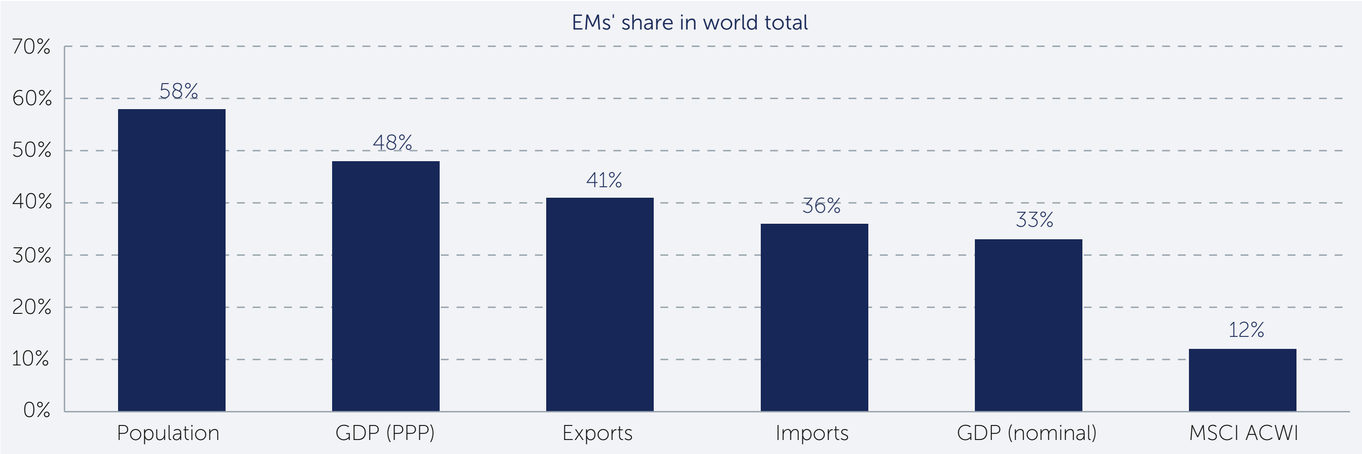
7. The savings gap represents the amount of money required in each country (including contributions from governments, individuals and employers) to provide each person with a retirement income equal to 70% of their pre-retirement income.
8. Millennials Are Good At Saving, But Investing? Not So Much, Andrea Coombes, Forbes, 13 March 2018
9. Can Student Loan Debt Explain Low Homeownership Rates for Young Adults?, Consumer & Community Context, January 2019, vol.1, The Federal Reserve System

## What is the antidote for this situation?

### Considering high return assets

Emerging markets present high-return (and of course high-risk) investment opportunities. Perhaps a lower investment return environment in the US might prompt investors to seek opportunities in EM. As a starting point, EMs are massively underrepresented in many asset class benchmarks. For instance, as shown in the chart below, EMs make c60% of the global population, c50% of the GDP (on PPP basis), c35% of global trade and more than 30% of the world GDP (in nominal terms). Yet the share of EM in MSCI ACWI is just below 12%. This underrepresentation of EMs in global benchmarks might provide the active managers, a chance to look for opportunities outside developed markets.

**EMs have been very under-represented in the equity benchmarks**




Source: MSCI, IMF WEO, World Bank

# Bracing for lower long-term equity returns

### Prefer thematic investments over passive investment styles

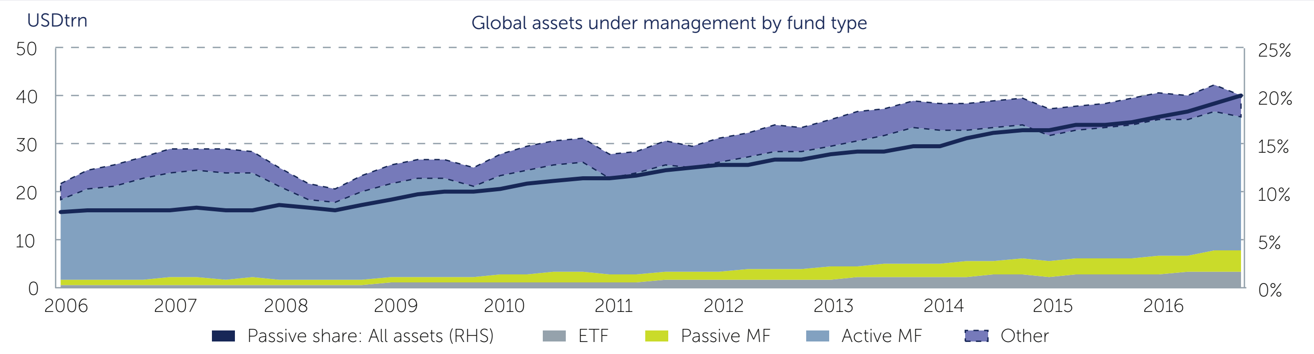
Thematic investment styles could help generate excess returns in a low-return environment. Thematic investing, as defined by Financial Times, is a top-down investment approach with a focus on broader, macroeconomic themes that a fund manager can use to identify strong companies. This not only allows scope for generating higher returns (because of targeted investments into a macro theme where the investor has high conviction), but also in many cases allows for diversification of opportunities (thematic baskets are cross-sector, cross-country and hence they diversify sector and country risks). However, the scope of thematic investment could be very broad, with several risk profiles, several investment time horizons (mostly longer than those for tactical investment).

For our thematic research, keep reading our "The Equity Thematician"!

### Box-1: Active vs. Passive debate goes live

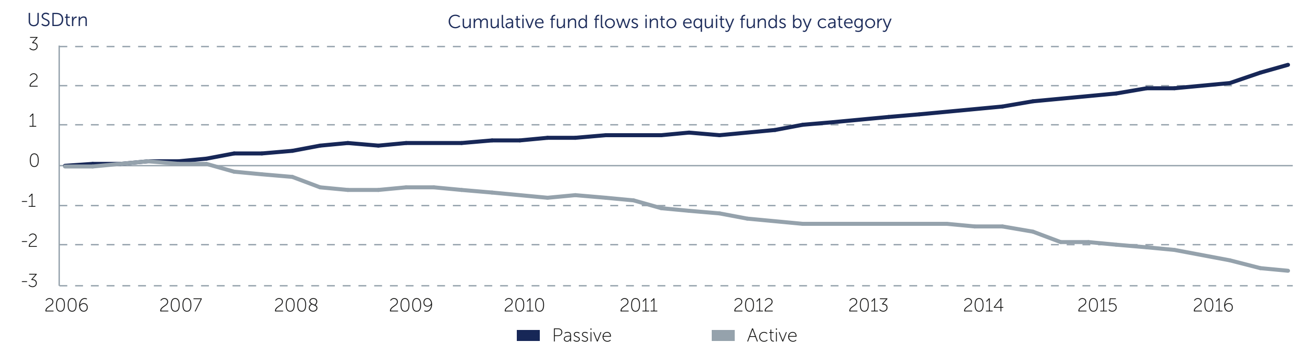
The rise of passive investments was one the defining features of the last decade for equity markets. Passive investment managers kept their promise – they delivered market returns at lower costs. Active managers though, struggled to outperform especially given the costs associated. According to Morningstar, in the US, just 36% of active managers both survived and outperformed their average passive peer over the 12 months through June 2018. Europe-domiciled active managers survived and outperformed passive peers on average in just two of the 49 categories between 2008 and 2018. Even in EMs such as Asia or Latin America, less than 50% of active funds outperformed.

**Size and share of passive investments has risen strongly since the Global financial crisis of 2008/09**




Notes: "Other" includes investment fund assets of closed-end funds, hedge funds, insurance funds, investment trusts and pension funds | Source: Lipper, BIS

**Especially in equities, there has been a rotation into passive out of active funds**




Source: Lipper, BIS

However, this strong relative performance of the passive funds coincided with rising markets. The question now is whether this dominance of passive funds will survive in a low return environment that we are envisaging. Shifting of focus to complete passive investments has led to a moderation in risk perceptions. Structurally, the shift to passive investments could mean lower risk but also, as often missed, lower returns.

## Conclusion

The current US economic expansion is one of the longest in history. Returns from the US equity market have been above average over the past ten years. Looking ahead, returns from this asset class are likely to be lower. Demographic support is fading, this along with lower productivity growth and pension financing stress are likely to result in slower GDP growth. Inflation, which has remained subdued over the past decade, will likely show up its head in the coming years, in our view. This should put upward pressure on long-term interest rates. Both rising inflation and long-term interest rates have not been good for equity performance and valuations. Corporate profits – which have been flying high in recent years – are likely to moderate looking ahead. Rises in interest burden thanks to elevated debt levels and rising interest rates, increases in margin pressures due to input cost inflation, and reversals in globalization are likely to put pressure on corporate profits. Valuations look stretched and they are certainly not at levels that have in the past triggered a meaningful and sustained positive performance from US equities. The equity risk premium and therefore the cost of equity is likely to rise as some of the trends that have held ERP low in recent decades reverse.

Lower equity returns are likely to have wider implications for a range of economic segments – including investors, asset managers, students and policy makers. Against the backdrop of pensions being underfunded (and unfunded in many cases), the funded portion is likely to face lower returns. Retirement planners and wealth managers need to consider longer time frames to generate a certain level of income/wealth from financial markets. Rising savings will translate into weaker consumption trends in consumer-led economies. As university endowment funds face lower returns, students' cost rise on the backdrop of already high levels of student debt. Asset managers face margin pressure and those with a cost advantage outperform. Lower expected returns on the benchmark indices allows scope for active managers to outperform.

Notwithstanding the likelihood of substantially lower long-term equity returns, the asset class remains an indispensable component of any global multi-asset approach as bonds and cash are unlikely to deliver the returns required by investors. Rather, good returns are increasingly likely to be generated by those asset managers that are able to capture the winning countries and sectors in a world that will be characterized by more volatility and by returns that are on average lower. Informed decision taking, reflected in thematic investing, and risk-adjusted investing in high-return assets, like emerging markets, will still allow for the possibility to beat those benchmarks, which are likely to deliver lower returns.

Our Investment Strategy and Investment Advisory teams have identified a number of themes that will allow you to take advantage of long-term trends, which are also in line with our house view. Please reach out to your relationship manager to see what we can do to help you navigate what we see as a rather low-return environment in the coming decade.

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## Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTTNews
4. Reuters
5. Gulfbase
6. Zawya

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