INVESTING IN A LOW-RETURN WORLD: AVOIDING PORTFOLIO PARALYSIS

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Introduction

Is your investment program built to deliver on long-term objectives? Or is it in danger of succumbing to portfolio paralysis, stuck in neutral as global investment returns drift lower in the future?

The easy-money policies from central banks around the world have stimulated markets and fueled significant price appreciation. Low interest rates, subdued inflation and compressed risk premiums have bolstered equity valuations, powering investment returns.

As investors wonder how much further markets can run and whether a painful correction lies ahead, it may be time to contemplate a different scenario as the Federal Reserve continues to withdraw its monetary stimulus. Instead of a dangerous unwinding of recent gains, perhaps a more likely outcome is a protracted period of underwhelming returns across asset classes. With cash rates at zero percent and future cash rates expected to remain low as well, the likelihood of asset returns in line with recent history is low. To this end, low investment returns will likely pose a tremendous challenge to most investors.

Pensions and endowments expect investment returns to spur portfolio growth (often, alongside contributions/ fundraising into the investment program) to offset benefit payments or planned spending. Similarly, individual investors expect investment returns to enrich their portfolios in order to support retirement goals or preserve/ grow wealth to aid current or future generations. Lower returns throw a wrench into these financial aims and objectives while forcing difficult decisions.

A low return environment means investors will face difficult choices, including decisions regarding funding, spending/ payouts, and investment return targets/ risk tolerance. As an example, a $1 billion investment program with an 8% investment return target would expect to have $4.7 billion in assets after 20 years (assuming zero net cash flows for the sake of simplicity). If investment results fell short of expectations, delivering only 6% instead of 8%, the assets would total $3.2 billion, or $1.5 billion short of the stated goal. Investors managing this program would face the challenge of making up that shortfall through contributions/ fundraising or restructuring how money is distributed.

LOW INVESTMENT RETURNS WILL LIKELY POSE A TREMENDOUS CHALLENGE TO INVESTORS

Adjusting how much comes in to an investment program as well as how much gets paid out can be structurally difficult, and is beyond the scope of this analysis. The target return of an investment program can be addressed more readily. In order to seek higher returns, investors have two choices: take more risk (and increase return expectations proportionally, assuming the efficiency of the portfolio is maintained) or take risk more efficiently and increase return at the same level of risk. Simply becoming efficient may not be enough: more efficiency at higher risk levels may be required.

To be sure, this environment of lower returns may be short-lived or may not be imminent given continued support from central banks. In fact, so far

our predictions for lower expected returns have been unfounded as returns continue to be robust. Furthermore, long-term return expectations, while somewhat subdued, appear able to support return targets for many investors (long-term yields remain well above short-term yields). Also, better than expected global economic growth could fuel higher returns across markets while allowing economies to work through ongoing deleveraging challenges.

Despite this possibility, we believe investors must rethink their approach, given the likelihood of a trying, low return environment. To this end, investors will need to embrace a forward-looking view, put in place a multi-disciplinary risk management function, and exhibit a willingness to take on smart risks. This is essential in order to succeed in a low-return world and improve the chances of accomplishing long-term financial goals. By recognizing the reality of prospective return expectations, investors can adapt their programs to navigate this potential landscape, allowing investment returns to continue to support goals, while avoiding portfolio paralysis and forcing challenging decisions around funding investment shortfalls or restricting outflows from the program.

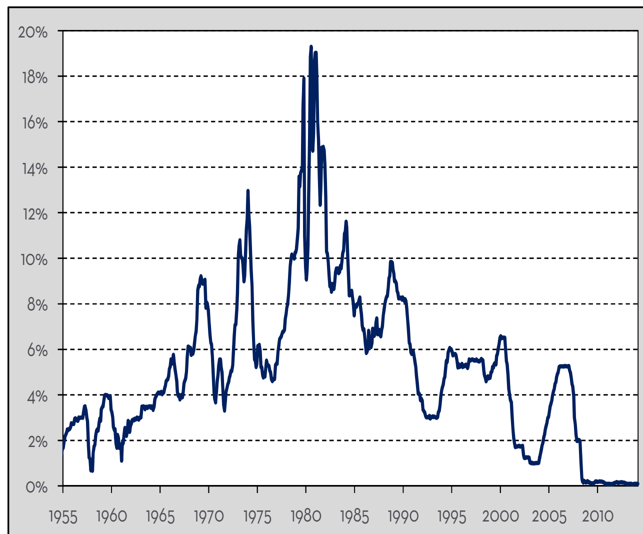
INVESTORS SHOULD EMBRACE A FORWARD-LOOKING VIEW, MULTI-DISCIPLINARY RISK MANAGEMENT, AND SMART RISKS

How Did We Get Here?

Investors have experienced tremendously positive performance across capital markets. This is true not only over the past five years as markets recovered from the global financial crisis, but also more profoundly over the last 30 years as interest rates, credit spreads and inflation steadily moderated, while economic growth, equity valuations and commodity prices expanded, collectively offering a set of positive tailwinds to markets.

The globalization of our economy brought efficiencies in the supply chain and production process and allowed companies to tap new markets and areas of growth. Advances in technology further increased efficiency and powered economic growth. Interest rates and debt levels also played a critical role in determining investment outcomes. In 1981, the federal funds effective rate

Exhibit 1: Federal Funds Rate (1955- Present)



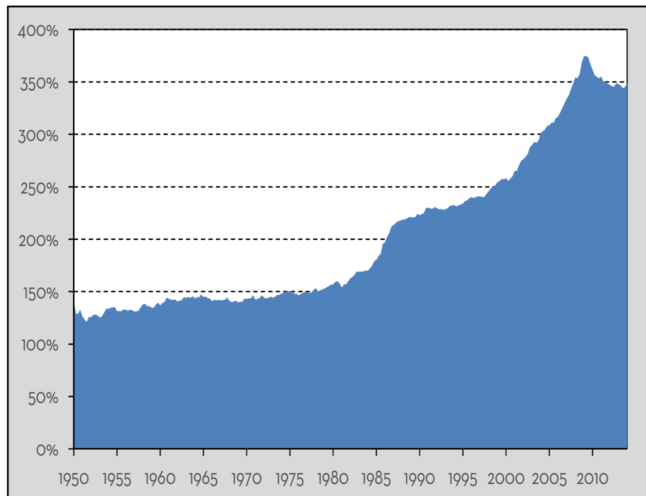
Source: St. Louis Federal Reserve

peaked at over 19% (Exhibit 1). Thereon, yields consistently compressed, spurring investment returns. Business cycles ebbed and flowed throughout this period but the starting point and downward trend in rates had two powerful implications for markets:

- Higher rates provided room for central banks to stimulate markets and promote consumption through each economic slowdown.
- Falling rates led to lower debt-servicing costs, allowing debt to expand relative to GDP (Exhibit 2), further fueling consumption and boosting asset prices.

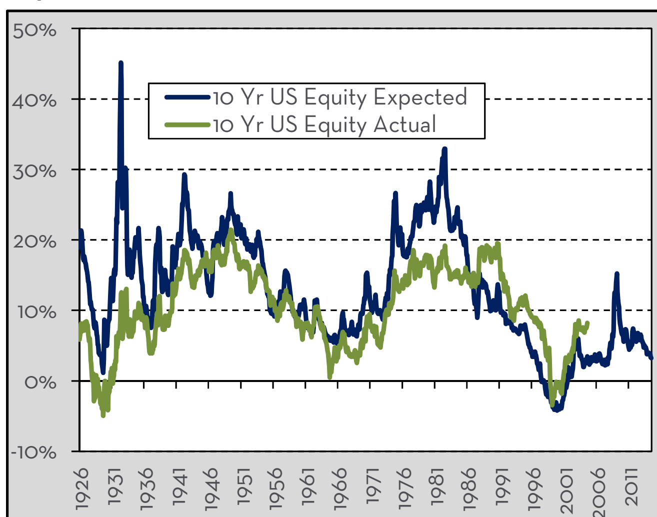
This cycle of stimulation and debt-induced consumption hit a brick wall once short-term interest rates hit zero. A subsequent unwinding of debt

Exhibit 2: Ratio of US Debt to GDP



Source: St. Louis Federal Reserve

Exhibit 3: Rolling 10-Year Expected and Actual Returns for US Equities

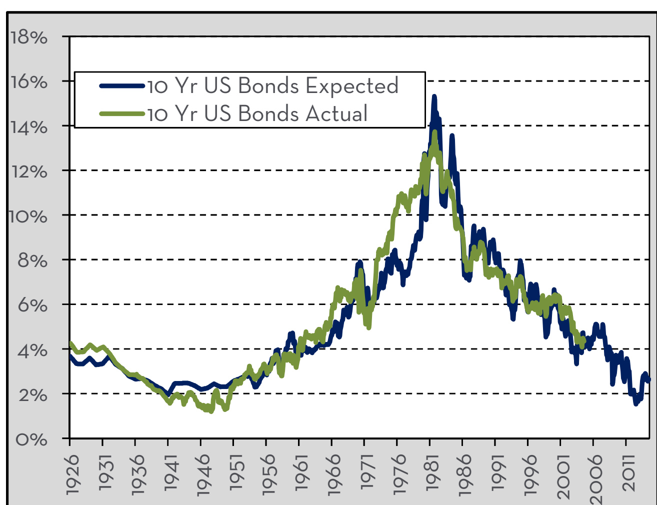


Source: Shiller Data, St. Louis Federal Reserve, NEPC

levels and global deleveraging created the need for massive stimulation but there was no rate flexibility to do so. As a result, the Fed and other central banks were forced to take unprecedented steps, including quantitative easing and programs designed to purchase bonds and drive rates lower along the yield curve.

Traditional central bank interest rate policy uses interest rates to moderate consumption through the supply of and demand for credit. Lower interest rates encourage borrowing and spending. On the other hand, an increase in interest rates curbs the appetite for borrowing and encourages saving. Quantitative easing, instead, stimulates through the wealth effect. By purchasing government-issued bonds (driving up bond prices and pushing down bond yields), central banks make bonds less attractive to prospective investors. Faced with a choice, these (hopefully) rational investors on the margin choose to invest in riskier assets such as corporate credit and equity. As these securities are bid up, owners of these assets see their balance sheets strengthen and are emboldened to spend more. While the transmission of monetary policy is not as clean as with traditional central bank rate management, the economic effect can be the same.

Exhibit 4: Rolling 10-Year Expected and Actual Returns for US Bonds



Source: St. Louis Federal Reserve, NEPC

Accommodative central bank policy like the Fed purchasing bonds to the tune of $1 trillion a year—and at least proportional balance sheet expansion from the Bank of England, Bank of Japan and the European Central Bank—has triggered powerful price increases across capital markets. That increasing wealth has coincided with higher consumption and (modest) economic growth.

The Outlook

Unfortunately, it is unlikely that these tailwinds will persist. Cash rates sit at zero percent. While recent robust returns fly in the face of predictions of a muted environment, the fundamentals will allow the truth to be stretched only so far. Further valuation expansion or spread tightening, while possible, would seem less likely, limiting expectations for returns. At this point in the cycle few can say there are readily available assets that are clearly cheap. Combining lower yields with tight risk premiums suggest lower total returns across markets.

Investors typically go through a rigorous process to set fundamental forward-looking expected asset class returns. (At NEPC, we attempt to do this annually, updating five-to-seven-year forecasts at the beginning of each year.) But over a long enough time horizon, total yield plus a valuation adjustment to long-term averages serve as a reasonable proxy for expected returns.

In this paper, we show rolling 10-year expected and actual subsequent returns for US stocks (Exhibit 3) and bonds (Exhibit 4). While not precise, taking total yield and a cyclically-adjusted valuation measure expected to move toward a long-term average over 10 years provide a strong indication of what we can expect over the next decade. Similarly, starting yield for bonds drives expected and actual returns.

This approach is not omniscient. One-year returns can vary radically and even 10-year returns can show significant variability relative to expectations. Changes in yields and valuations over that period will affect the actual outcome, but this approach can be a useful reality check when setting expected returns. Without a doubt, it is painfully humbling when we look at most recent measures for expected returns: US equities are expected to return 3.2%, while US bonds are expected to gain 2.6%. These expectations offer a challenging starting point and a high likelihood of falling short relative to long-term return targets.

Sadly, this issue extends beyond US capital markets. Bond yields in the developed world reflect challenging underlying economic conditions symptomatic of many mature economies. The sovereign bonds of many European countries offer yields lower than those in the US. Similarly, Japanese officials remain flummoxed by chronically low bond yields. Yields in the developed world reflect tough growth prospects and feeble growth limits prospective returns for equities. As in the US, low yields across markets lead to muted return prospects across the rest of the developed world.

What Can Investors Do?

Low investment returns will likely pose an immense challenge to most investors. While many investment programs are structured as permanent capital, the simple truth holds that over the complete life of an investment program, contributions plus investments will equal total expenditures. Investment returns lower than those historically experienced pressure investment programs to adjust funding levels, manage outflows or shift objectives.

A low return environment means investors will face difficult choices. As investors attempt to meet long-term objectives in a more taxing environment, they have the following three basic levers to potentially adjust:

- *Contribute more into the investment portfolio* – If investment returns are lower, one way to reach the same long-term objective is to increase contributions. This can defy budgets of and planning by individuals and institutions.

- *Adjust goals/ payouts* – For pensions, liabilities are accrued as promises to employees to pay a fixed benefit at retirement. These promised benefits are not easily altered. Similarly, endowments have spending needs in support of a broader organization, for instance, a university, hospital or a charitable endeavor. The outlays from these organizations have an enormously powerful and positive impact on their communities. Shifting to lower levels of spending has harmful knock-on effects. Similarly, individuals spend years planning retirement, or building family wealth. This planning is complex and not easily undone.

- *Adjust the investment program to maintain a similar expected investment return objective* – The ability to bring about this type of change will be based on each investor's decision-making process, portfolio liquidity and constraints for taking risk. To increase expected returns from low levels, investors can either increase risk or take risk more efficiently.

To this end, we believe investors will have to reconsider how much risk is taken and how efficiently the investment program pursues that risk in order to successfully navigate this environment. This means being forward-looking, employing rigorous risk management, and identifying smart risks that offer outsized returns. We discuss these in more detail below:

Forward-Looking – As noted above, analysis of the fundamental drivers of investment returns suggests that future returns are likely to be low. Investors expecting portfolios to earn returns similar to long-term history are likely to be disappointed. Investors willing to face this reality will be better prepared to address the looming specter of subdued investment returns. Those willing to address these challenges sooner will be more likely to meet their long-term objectives than those who defer difficult decisions in the hope markets will bail them out. Investors employing a forward-looking approach will also be better positioned to identify attractive market prices and dynamically adjust portfolio allocations to take advantage of these opportunities.

Risk-Aware – Investors should assess their risk in a holistic fashion, understanding risk from various perspectives. This means understanding forward-looking portfolio volatility as a risk, but not using this single standard deviation measure as the only narrow definition of risk. Instead, investors should understand the sources of volatility and

the manner in which they have distributed their risk across asset classes. Investors should also analyze various economic scenarios in order to understand a portfolio's exposure to various extreme environments. Portfolio liquidity should also be examined and tested under different conditions. Once analyzed, we believe many investors will find a risk-balanced approach an appropriate solution.

A risk-balanced approach remains an efficient starting point for asset allocation across various economic scenarios. While tilts can be made around this starting point, we believe this approach not only offers a return profile less exposed to portfolio drawdowns, but is also better able to deliver consistent performance across various economic growth and inflationary regimes. Given the ongoing uncertainty regarding the strength of the recovery of the global economy, we believe a balanced approach is critical to navigating this trying environment. As investors assess the lower-returns landscape, a balanced allocation across risk exposures can serve as a more prudent alternative to simply expanding overall portfolio risk.

Taking Smart Risks – Smart risks likely have characteristics of attractive valuations (limiting downside), higher relative yields (either contractual income or higher overall interest rates reflecting higher credit risk), and often less liquidity in the form of either longer lock-up structures or less capital flowing into these markets due to perceived risks. Taking smart risks may also mean avoiding the temptation to chase risks at certain times, preserving dry powder for potentially more attractive opportunities in the future.

Often, taking these smart risks will be uncomfortable as their attractive valuations stem from the challenges they face and their potential for volatility and illiquidity. Not all risky investments will make sense; investments that do will have high return expectations and strong fundamentals to offset the threat of potential drawdowns.

These smart risks will likely evolve over time. Current opportunities include the following:

- *Emerging Market Equities and Debt* – Many economies within these markets are facing challenges and have significantly lagged developed markets. In China, the largest emerging market, attempts at pivoting the exports-driven economy to a more consumption-oriented one will help its long-term competitiveness and sustainability, but these efforts have stunted growth in the short-term. In addition, several economies within emerging markets have faced balance of payments challenges as foreign capital inflows evaporated in the last few years. Geopolitical issues in some of the least stable markets, for instance, Russia, Argentina and the Middle East, have led to the potential for further limited returns. That said, valuations in emerging equity markets remain attractive relative to the developed world. Also, bond yields are significantly higher, economic fundamentals remain stronger as these markets grow, debt levels remain low, and the burgeoning middle class continues to consume more. In these markets, creative implementation, such as investments in small cap equities or flexible, less benchmark-sensitive approaches for broader exposure to debt, can provide targeted exposure to attractive themes within this broad category. Given the different conditions across countries, we believe active management is critical to long-term investment success.
- *Middle-Market Direct Lending* – Banks continue to pull back from markets in which they have been the traditional providers of capital as they face more conservative capital reserve requirements under Basel III. In particular, loans to small- and medium-sized enterprises offer attractive yields as relatively healthy companies seek capital. Institutional investors have had the opportunity to provide this capital, often in the form of well collateralized loans at significantly higher yields than public markets. This is an evolving global opportunity for investors. Yields also remain fairly attractive in Europe.
- *Unconstrained Strategies* – Investors will likely have the opportunity to identify particular asset classes with attractive pricing and allocate capital to exploit this mispricing. Yet, many investors will be better served if they select active managers with skill to exploit inefficiencies within or across asset classes. Investors are best positioned to take advantage of these opportunities across asset classes through Global Asset Allocation, or within asset classes through Absolute Return Fixed Income or unconstrained flexible equity strategies.

- *Patience/ Dry Powder* – At this time, when many markets appear fully valued, opportunities to take smart risks can be limited or narrow. Discerning investors need to recognize market environments in which it is not necessary to put to work every last opportunistic dollar. Today's environment requires a careful balance between allocation to attractive opportunities and preservation of some amount of liquidity and dry powder to be utilized when market dynamics change and more appealing opportunities emerge.

Conclusion

It may be difficult to look back on the last three decades of investing and call them the glory years. Memories of that time include the tech wreck, the financial crisis, multiple decades of deflation in Japan, the threat of debt defaults in parts of Europe, and several crises in emerging markets. Yet subsiding inflation, declining bond yields, and expanding valuations helped deliver outsized returns to investors. Portfolios generally delivered robust results for investors, enabling many investors to meet or exceed their financial objectives over that time. Unfortunately, the current market offers low cash yields, compressed risk premiums, and, as a result, low overall expected returns. If left untouched, portfolios that historically produced robust returns for investors may be caught in paralysis, delivering muted returns well short of long-term portfolio objectives.

Investors willing to be realistic and face the demands of a low-return world will need to embrace a forward looking approach, a comprehensive risk management function, and a willingness to dynamically take smart risks. Those able to embrace these characteristics and address challenges head-on will be more likely to experience success in a low-return world and improve their chances of meeting long-term financial objectives.

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