Second Quarter Commentary

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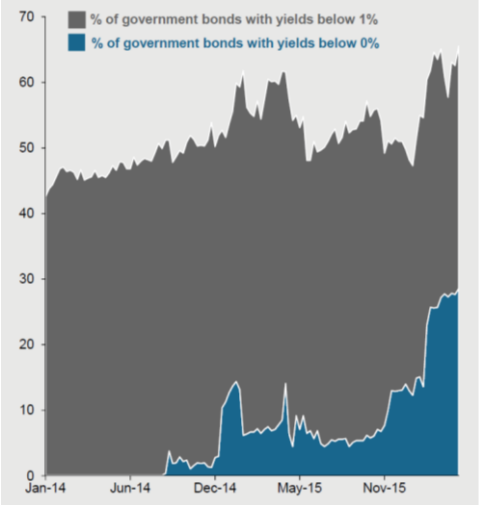
Game plan for a low return decade

"The outlook for capital market returns over the next decade is largely a function of the starting point. Following a 34-year trend decline in global bond yields, virtually all assets are expensive by historical standards. As a result, the greatest positive re-pricing of financial assets in recent centuries is behind us…For long-term investors, the implication is that prospective real and nominal returns will be low by historical standards, and the trade-off between risk and reward will be comparatively disappointing. Many investors will seek alternative approaches to escape the fundamental challenges of generating good returns in a moderate-growth world of expensive assets, but on balance to no avail." – MRB Partners, May 2016

Even though most investors are encouraged to look long term when it comes to investing, most market pundits and economic commentaries run counter to that and tend to have a much shorter term focus, typically estimating where things will be one year down the road. Worse, business networks like CNBC dedicate an hour on a daily basis to shows like "Fast Money", in which Wall Street traders offer their latest on short term stock trades, frequently flip flopping on particular ideas from week to week. Unfortunately, most of this is simply to encourage viewership, and adds little to no value for long term investors. That being said, we can understand why the producers of these programs design them as such, they are indeed more interesting for the average viewer than an hour dedicated to a deep dive into economics and what it means five or ten years into the future. However it is the latter that indeed is of greater value to most investors and their long term planning.

Global financial assets are expensive from a long term perspective. From government bonds and GICs, to stocks, relative to historical valuations, the total return possibility from these in the next decade is likely to be modest. The biggest challenge to portfolio returns is the contribution from fixed income investments. In particular, this challenge is more pronounced for retirees and for those approaching retirement. Whereas a more conservative portfolio structure is appropriate for this group of investors, the generational low interest rates equates to the possibility of annualized zero to negative real rates of returns in government bonds and GICs over the next decade. As *chart 1* illustrates, this conundrum for savers is a global phenomenon. Over 25% of the world's nominal government bond yields are currently below 0%. What this means is for every dollar invested in that bond, at maturity, you are guaranteed to have less money than you started with. When government bonds yielding less than 1% are included in the analysis, the number rises to about 65% of all government bonds. Canadian government bond yields track this global picture, with the two year and the five year benchmark bonds having annual yields of 0.65% and 0.79% respectively.

Chart 1: **Government Bonds with Low or Negative Yields**



Source: JPM Morgan Asset Management

The trend in declining global bond yields is now on its 34th year. For borrowers, this has been enabled households to accumulate more debt, and be able to service these higher debt loads. For savers, the challenge is to be able to generate a rate of return above inflation without assuming undue investment risk. The example in *Table 1* illustrates a balanced 50% fixed income and 50% stock portfolio with an assumed bond

portfolio return of 1.50%. With this asset mix, a total portfolio return of 6% requires a total annualized return of 10.50% from stocks. Table 2 illustrates the stock return requirements with a more moderately conservative asset mix of 70% fixed income and 30% stock. A 6% portfolio return with this asset allocation strategy requires a 16.50% rate of return in stocks.

Table 1: **Asset Mix, 50% Bonds 50% Stocks**

Fixed income	Portfolio return	Return needed from stocks to achieve portfolio return
1.50%	4%	**6.50%**
1.50%	5%	**8.50%**
1.50%	6%	**10.50%**
1.50%	7%	**12.50%**

Table 2: **Asset Mix, 70% Bonds, 30% Stocks**

Fixed income	Portfolio return	Return needed from stocks to achieve portfolio return
1.50%	4%	**9.82%**
1.50%	5%	**13.15%**
1.50%	6%	**16.50%**
1.50%	7%	**19.82%**

Many factors influence stock returns over the long term, with the global economic growth rate playing an important role in our outlook. Post the Great Recession of 2008, the current economic expansion has been subpar, with the economies in developed markets growing at about half the rate in the last 10 years compared to the economic growth rate over the past 25 years. Conversely, emerging market economies have experienced good growth in the last decade despite the most recent slowdown in China. As the economic contribution from emerging markets has gained in prominence, the faster growth rates in those regions have essentially supported global economic growth. Going forward, global growth will be dependent on this continuance of emerging market growth and economic development.

Global equity market returns in the coming decade should reflect this dynamic, as total returns from emerging market equities should outperform the total returns from developed market equities with a large portion of the returns in developed market stocks coming from dividends. Relative to government bonds, stocks are cheap on both a valuation and on a yield basis. However, relative to historical valuations, stocks are not inexpensive; it's just that government bonds are significantly overvalued. Thus the tactical asset mix becomes even more important for portfolio returns in the next decade. Focus should be on dividend growth companies, particularly as bond yields adjust higher in the first half of the upcoming decade. Buying equities on dividend yield alone may lead to mild disappointment, as these high dividend yields but no dividend growth stocks, could see their share prices negatively impacted when higher bond yields eventually attract more yield seeking investors. Emerging market equities should be positive for returns over this coming period.

The biggest challenge to the balanced investor in the next decade is the low contribution from bond returns, particularly in the next five years given the gradual normalization of interest rates. As a result, in the short term (up to 5 years), a higher allocation to cash and equivalents is appropriate as not much of an opportunity cost is lost versus bonds. As bond yields drift higher during this period, the eventual reallocation of cash back into fixed income should lead to better total returns for the latter half of the upcoming 10 year period. Currently, the fixed income focus is heavily skewed towards short term bonds and spread opportunities; higher yielding corporate bonds down the quality spectrum. An understanding of the challenges posed by low bond yields means either an acceptance of lower than historical portfolio returns, or a requirement to accept more risk for an opportunity to achieve the same historic level of return. Alternative approaches to investing (hedge funds, non-traditional strategies) are likely to be both expensive, and the results disappointing.

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