Investment returns to be very low. V3
2/5/16
by Bruce Baker, Puzzle Financial Advice

There have been many articles over recent times discussing the likely low investment returns ahead. For example:

- http://www.bloomberg.com/news/articles/2015-11-30/morgan-stanley-get-ready-for-a-period-of-low-returns-in-the-market
- http://www.puzzlefinancialadvice.com.au/Low_Returns/160415_Mauldin-Zirp-nirp-killing-retirement-as-we-know-it.pdf
- http://www.puzzlefinancialadvice.com.au/Low_Returns/160414_Woody_Brock-News-that-should-shock-nobody.pdf
- http://www.puzzlefinancialadvice.com.au/Low_Returns/160501_AFR_Warren_Buffett-Low_rates_help_business-hurt_savers.pdf
- http://www.puzzlefinancialadvice.com.au/Low_Returns/160502_AFR_Budget_2016_Low_yields_to_swamp_pension_savings.pdf

Here is the problem in a nut-shell.

- The simple maths from the markets suggests very low returns in Western developed markets for maybe 20 years - at best .... overlain with high volatility. A very uncomfortable mix.
  - The simple maths behind the forecast for low investment returns goes like this:
    - Portfolios tend to be primarily made of bonds, shares and property.
      - If we use the US share markets as a proxy for **Western shares** - current valuations using Professor Robert Shiller's long-term research, suggests that US share market return over the next 20 years will average something like - between -2%pa real and 0% real compounded.
        - So maybe no real returns from Western shares over the next 20 years?
      - **Western government bonds** of 5 year durations, range from -2%pa to 2% pa. Say the average is 0%pa.
        - So maybe no nominal returns from bonds over the next 5 years.
      - **Western Property.** You sure have to expect that the same drivers that have driven US shares to extreme valuations have done so as well in other asset segments in the West including property. I do not have the data to prove this. But I can see this:-
        - A financial planner colleague mentioned to me a couple of weeks ago, that he saw a commercial property sell in Sydney at 5%. (Very expensive on a historical basis). He recalled seeing commercial property getting down to 6% yield in 2007, just before the GFC caused commercial property markets to freeze ..... and properties which sold did so at large discounts to 2007 valuations.
        - A historically largest house price bubble in Australia.
        - And US house prices are pushing well up into bubble territory again.
  - And of course, if Western bond yields (for what-ever reason) rise sharply, then all of these asset sectors should be expected to fall substantially in value.

So just say, for the sake of this discussion, that average Western investment portfolios averaged 1%pa-2%pa over the next 5, 10 and 20 years .... and just say, the market volatility was such that on any given year the portfolio might be up or down by 15%-20% .... **Bottom line:** The current state of Western investment markets creates immense uncertainty about investment returns over the next 5, 10 and 20 years.
http://www.puzzlefinancialadvice.com.au/Low_Returns/Investment_returns_to_be_very_low_160501_Puzzle_V3.pdf

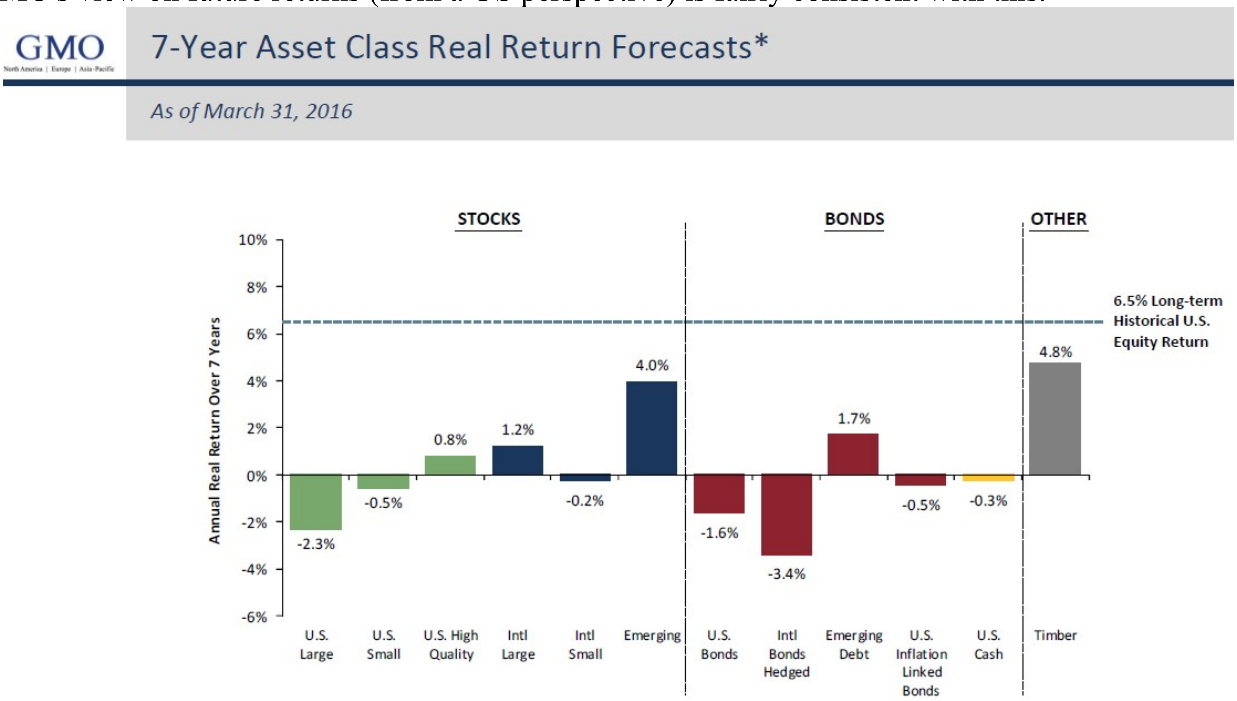
Some discussion on the above points:

Let me make the case very succinctly. 2 of the major asset assets are shares and bonds (fixed interest).

- Much of developed world government government bonds is in negative yields. See Appendix A. Also see attached articles:
  - http://www.afr.com/business/banking-and-finance/financial-services/why-investors-are-buying-bonds-at-negative-interest-rates-20160418-go91ss
  - http://www.afr.com/news/economy/reserve-banks-glenn-stevens-shoots-down-helicopter-money-desperados-20160419-go9vy9
- The US share market is in bubble territory. If you refer to Appendix B, this probably means that US shares on broad averages may get returns in the vicinity of -2%pa to 0%pa compounded over the next 20years.
  - And because Australian and European shares are probably in a long secular bear market (see Appendix B), those markets probably won't do much better on broad average.

And in the Western developed world, the same forces that have driven asset prices to such high levels (i.e. excessively stimulatory monetary policy), have driven many other asset prices (including property) to high levels …. suggesting (at least superficially) that returns on those other assets MAY be poor at best over the next 20 years.

GMO's view on future returns (from a US perspective) is fairly consistent with this.



So what do we do in response to this challenge?

And please do not get me wrong, this challenge is huge …. and this challenge really has been with us for a long time … i.e. since before the 2008-2009 GFC.

As long-term clients, you know what my answer is to this:-

- Emerging markets are likely to offer the best share market returns over the next 10 & 20 years. Evidence:-
  - The Alan Kohler/Gerard Minack Shiller P/E chart in Appendix B shows that at the end of 2013, **emerging market Shiller P/Es were about 11**, suggesting (from Shiller data) that over the next 20 years broadly/simplistically **the expected return are likely to be something around 5%-12% pa compounded** (I think that is real returns... would have to check).
  - This is relatively consistent with GMO's forecast above.
  - And as you well and truly know, the likely future economic growth (GDP growth) of the emerging world is likely to be far higher in the emerging world than in the West over the next 5, 10 and 20 years.
- Hedge funds.
  - Our hedge funds are specifically targeted to deliver return independent of share and bond returns …... particularly the trend-followers and the long-market market neutral Fund.
- Gold.
  - I think Gold bullion is part of the answer on the basis that gold bullion in US$ tends to do well when US real cash rates are negative.
- Be fairly defensive [high levels of cash, term deposits and short-dated government bonds] … because the volatility is likely to be fairly extreme at times.
- Be prepared to live within your means.
  - http://www.puzzlefinancialadvice.com.au/financialsecurityhow.htm

BEWARE THOUGH: Developed world central banks seem determined to take extreme measures to try to kick-start growth and try to prevent deflation. These measures (highly experimental) could well lead to surprising and unexpected outcomes … and we also need to remember that in these sorts of times there is a very real risks of global systemic financial system failure.

Appendix A. Negative yields on government bonds.

5-year German bonds – negative yields.

5 year Swiss bonds - negative yields.

5 year Japanese bonds - negative yields.

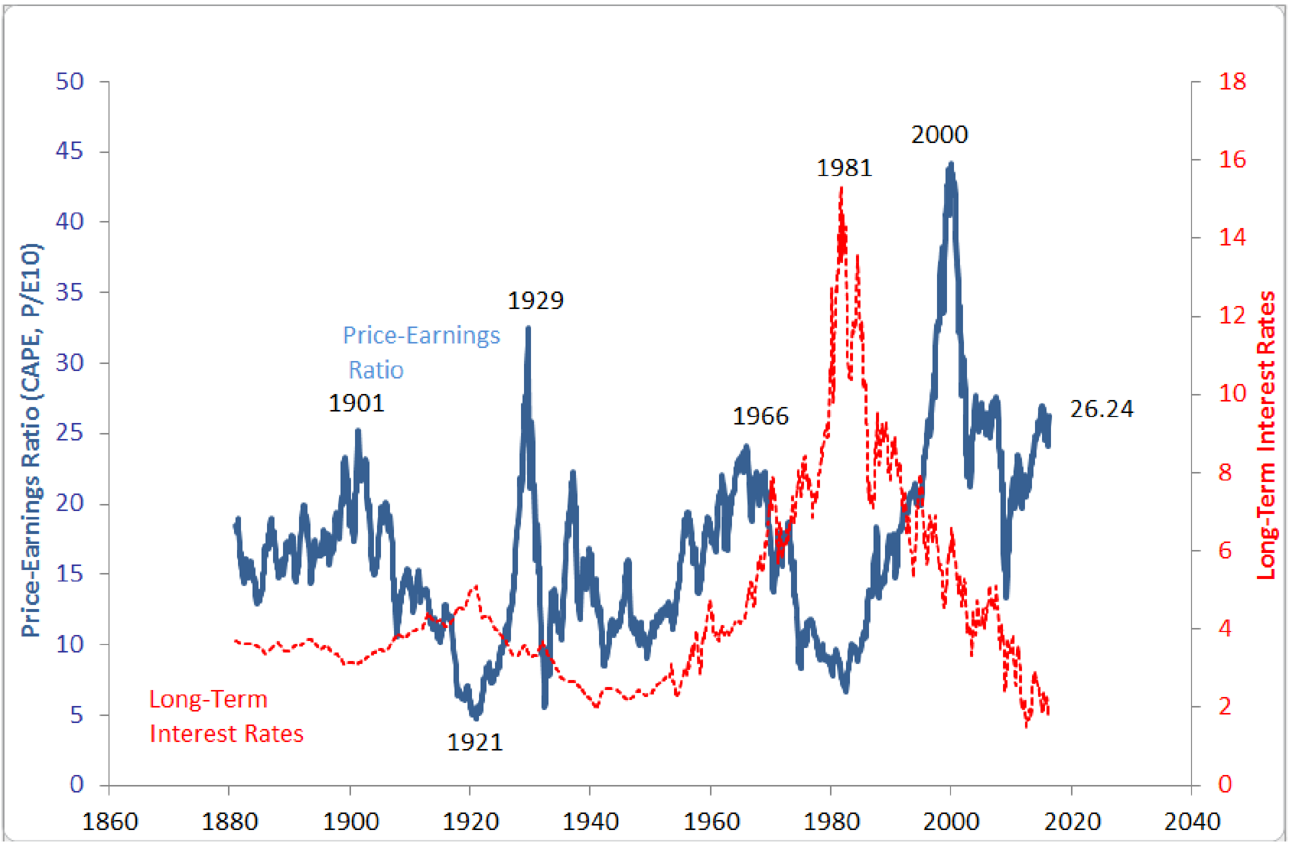
5 year UK bonds not negative yields – at least not yet. But very low.

US 5 year bonds not negative – at least not yet …. but very low.

Australia's 5 year government bonds are about 2% on the ASX for 2020 maturity - and probably going to go lower I think. (AFR 20/4/16 – GSBG20).   May 2021 is currently 2.16%pa in the wholesale market.

Appendix B. US future share market returns likely to be low or negative.

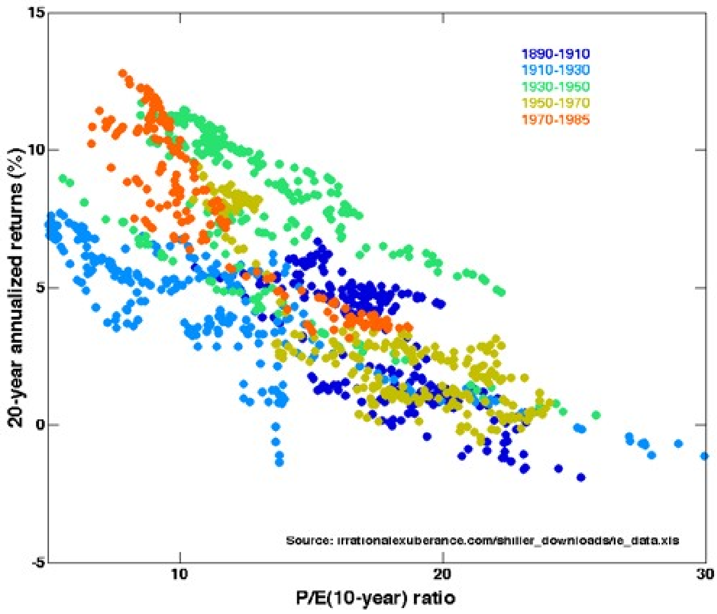
The Shiller P/E ratio for US shares is 26.24



This Shiller ratio is the best guide for future share market returns.

- http://puzzlefinancialadvice.com.au/Papers/Shiller_CAPE_PE10_as_a_guide_to_future_performance_130726.pdf

As this paper discusses, Shiller's historical data suggests that if you have a Shiller of 26, then the likely 20 year returns are somewhere between NIL and negative 2% pa compounded.

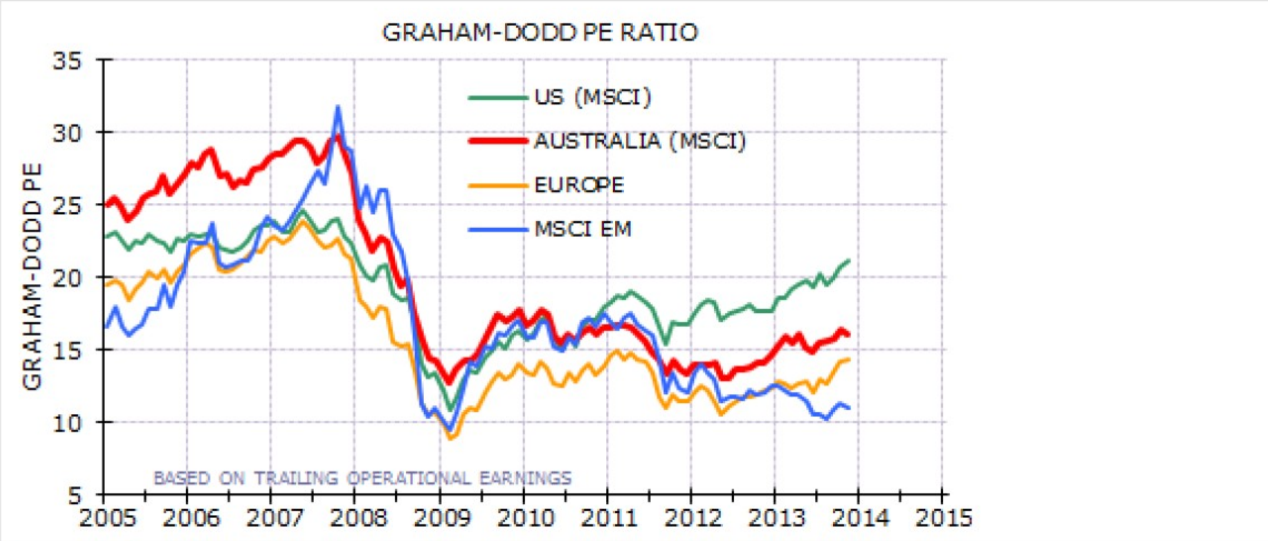


Is all the Western developed world as expensive as USA? Alan Kohler offered the following chart from Gerard Minack on 18/12/13.

Global Share Valuations

Posted 16 hours ago

Australian shares are valued higher than Europe and the emerging markets but below the US.



Source: Minack Advisers

While Australia and Europe are not as expensive as the USA, I believe that they are probably in long secular bear markets.

- http://puzzlefinancialadvice.com.au/Secular_and_Cyclical_Markets_13_141217.pdf
- http://puzzlefinancialadvice.com.au/Secular_trends_-_Australian_secular_bear_started_2007_04_150130.pdf
- http://puzzlefinancialadvice.com.au/Secular_trends_-_most_important_Asia_Japan_USA_Australia_150608.pdf

Appendix C. Emerging World Bond yields.


Russia 10yr (RUGE10Y INDEX) 5.079 -0.05
2014-10-15
Weekly
MA 160
16
14
12
10
8
6
4
2005
2006
2007
2008
2009
2010
2011
2013
2014


Pakistan 10yr (PKIB10YR INDEX) 10.02 0.05
2015-06-22
Weekly
MA 160
17
16
15
14
13
12
11
10
9
8
7
6
5
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015


China 10yr (GCNY10YR INDEX) 2.92 -0.02
2016-04-18
Weekly
MA 160
4.6
4.4
4.2
4
3.8
3.6
3.4
3.2
3
2.8
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016