RETIREWELL
WEALTH MANAGEMENT SOLUTIONS

eNewsletter
Exclusive Client Email Newsletter
7 October 2019

To Clients and Friends of Retirewell,

Investment Returns Are Likely to Slow over the Next 5 Years

NOTE: We recommend you print out this 6 page eNewsletter, for easier reading. If you have trouble printing this email, we have attached a PDF version. (Go and make a cup of tea or coffee and sit down for a good read!)

Introduction

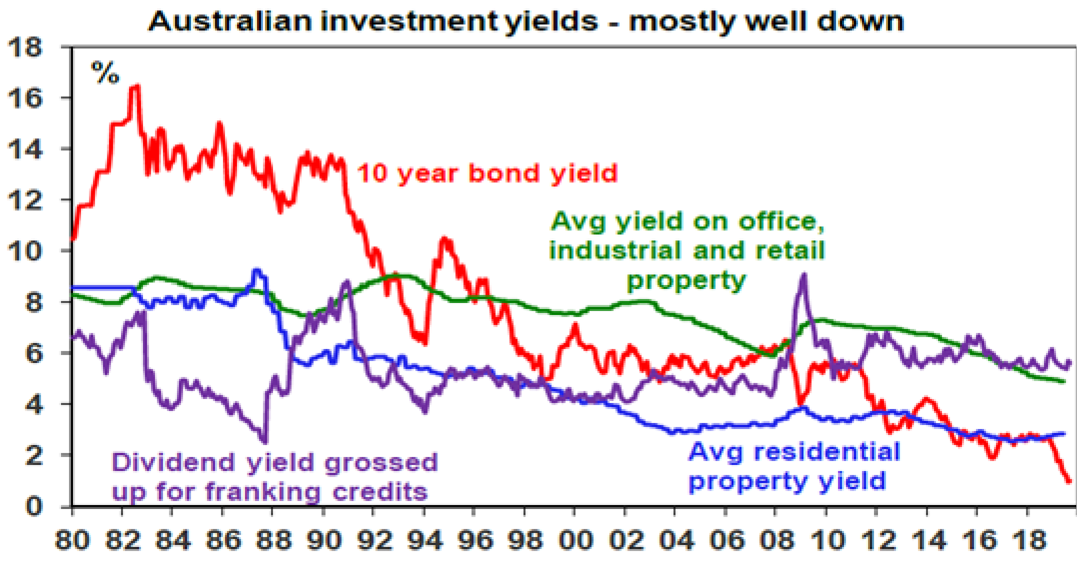
The past 10 years have seen quite decent returns for well diversified investors. However, shares and growth assets have faced climbing a wall of worry this decade, with a revolving door list of worries around public debt, the Eurozone, deflation, inflation, rate hikes, Trump, North Korea, China, trade wars, growth, house prices, etc. But returns benefitted from the recovery after the Global Financial Crisis (GFC) and the search for yield as interest rates have collapsed, depressing yields on most assets. But this inexorable decline in yields, points to eventually more constrained returns ahead.

Declining Yields = Falling Medium-Term Return Potential

Investment returns have two components: yield (or income flow) and capital growth. Looking at both of these components points to lower average investment returns over the next 5 years compared to the last five years. It's basic to investing that the price of an asset moves inversely to its yield, all other things being equal. Suppose an asset pays $10 a year in income and suppose its price is $100, which means an income flow or yield of 10%. If interest rates are cut, resulting in increased demand for the asset, as investors search for a higher yield, such that its price rises to $120 given the $10 annual income flow, its yield will fall to 8.3% (ie $10 divided by $120) as its price has gone up by 20%. So, yield moves inversely to price. But as yields decline it means a lower return potential going forward.

Since the early 1980s, investment yields have collapsed. Back then the RBA's "cash rate" was around 14%, 1-year bank term deposit rates were nearly 14%, 10-year bond yields were around 13.5%, commercial and residential property yields were around 8-9% and dividend yields on shares were around 6.5% in Australia and 5% globally. This meant that investments were already providing very high income so only modest capital growth was needed for growth assets to generate good returns. So, most assets had very strong returns and balanced growth super fund returns averaged 14.1% in nominal terms and 9.4% in real terms between 1982 and 1999 (after taxes and fees).

Over the last four decades, investment yields have mostly fallen quite sharply - see the next chart.



Source: Bloomberg, REIA, Jones Lang Lasalle, AMP Capital

Today the cash rate has just fallen to 0.75%, 1-year bank term deposit rates are 1.5%, 10-year bond yields are 0.9%, gross residential property yields (before deducting expenses) are around 3%, commercial property yields are just below 5%, dividend yields are still around 5.5% for Australian shares (with franking credits) but they are 2.5% for global shares. This points to a lower return potential for a diversified mix of assets. What's more, the capital growth potential from growth assets is likely to be constrained relative to the past, reflecting more constrained nominal economic growth.

Several megatrends are likely to impact growth over the medium term. These include:

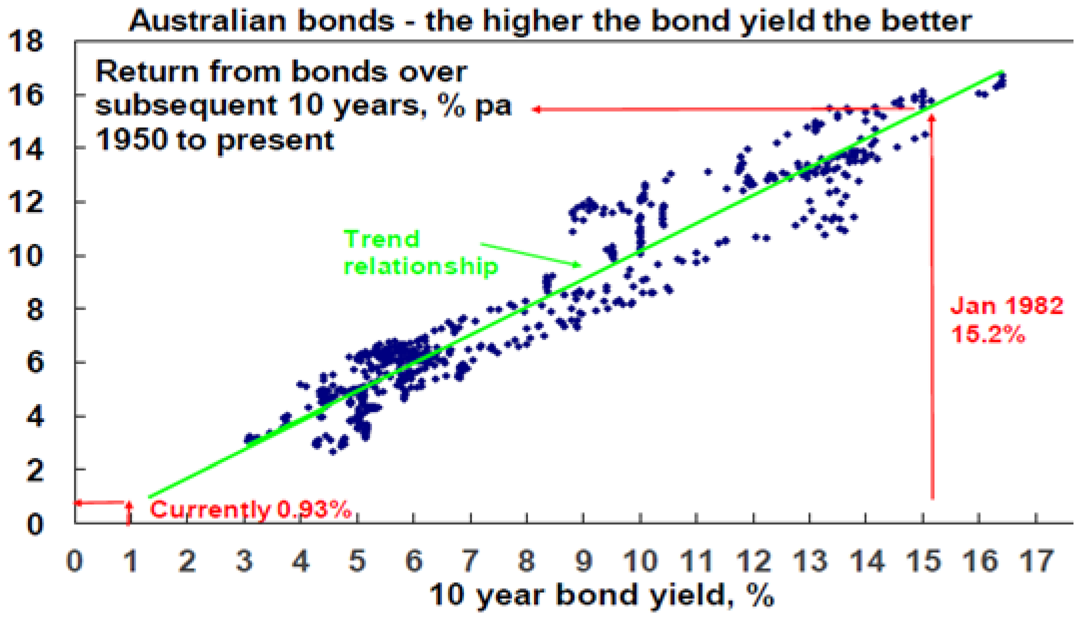
- Continued slower growth in household debt.
- An ongoing retreat from globalisation, deregulation and small government in favour of populist, less market friendly policies.
- A shift in corporate focus from profit to "balanced scorecards".
- Rising geopolitical tensions – notably as the US attempts to constrain the rising power of China as evident in the trade war.
- Aging and slowing populations – resulting in slowing labour force growth and rising pressure on public sector budgets.
- Technological innovation and automation
- Continuing rapid growth in Asia and China's middle class.
- Pressure to slow emissions & the impact of global warning.
- A large shift to sustainable energy as its cost continues to fall.

Most of these will constrain economic growth & hence returns.

Medium-Term Return Projections

To get a handle on medium-term return potential, we start with current yields for each asset class and apply simple and consistent assumptions regarding capital growth, reflecting the above-mentioned megatrends. It is best to avoid forecasting and to keep the analysis simple.

- For bonds, the best predictor of future medium-term returns is current bond yields as can be seen historically in the next chart. If a 10-year bond yield is held to maturity its initial yield (around 0.90% but falling) will be its return over 10 years). However, it is best to use 5-year bond yields as they more closely match the maturity of bond indexes



Source: Global Financial Data, Bloomberg, AMP Capital

- For equities, current dividend yields plus trend nominal GDP growth (a proxy for capital growth) does a good job of predicting medium-term returns.
- For property, we use current rental yields and likely trend inflation as a proxy for rental and capital growth.
- For unlisted infrastructure, we use current average yields and capital growth just ahead of inflation.
- In the case of cash, the current rate is of no value in assessing its medium-term return, so we allow for some rise in cash rates over time.

The latest return projections which result from these assumptions, are shown in the next table.

Projected medium term returns, %pa, pre-fees and tax

	Current Yield #	+ Growth	= Return
World equities	2.6^	4.1	6.6
Asia ex Japan equities	1.6^	6.9	8.5
Emerging equities	1.9^	6.9	8.9
Australian equities	4.3 (5.7*)	3.2	7.5 (8.9*)
Unlisted commercial property	4.9	1.7	6.6
Australian REITS	4.6	2.3	6.7
Global REITS	3.6^	1.9	5.5
Unlisted infrastructure	4.6*^	3.0	7.6
Australian bonds (fixed interest)	1.1	0.0	1.1
Global fixed interest ^	1.3	0.0	1.3
Australian cash	2.0	0.0	2.0
Diversified Growth mix *			5.6

*# Current dividend yield for shares, distribution/net rental yields for property and duration matched bond yield for bonds. ^ Includes forward points. * With franking credits added in. Source: AMP Capital.*

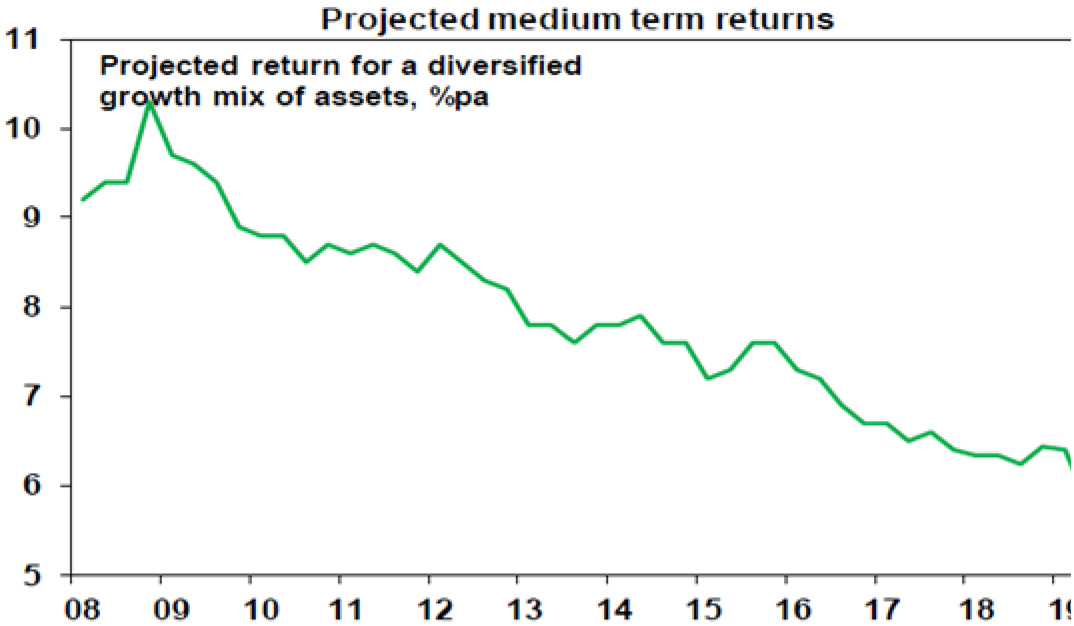
The second column shows each asset's current income yield, the third shows their 5-10 year growth potential, and the final column their total return potential. Note that:

- Inflation averages are assumed around or just below Central Bank targets.
- For Australia, a relatively conservative growth assumption has been adopted, reflecting slower productivity growth.
- Forward points in the return projections for global assets are allowed, based around current market pricing.

Key Observations

Several things are worth noting from these projections.

- The medium-term return potential has continued to fall, due largely to the rally in most assets and fall in investment yields. Projected returns using this approach for a diversified growth mix of assets have fallen from 10.3% pa at the low point of the GFC in March 2009, to 8.6% five years ago, to 6.2% a year ago and to now just 5.6%.



Source: AMP Capital

- Government bonds offer low returns due to ultra-low yields. Yes, bond returns have been strong lately as yields have collapsed pushing up bond prices. But this is no guide to future returns, particularly if bond yields stop falling. (How much further can they fall?)
- Unlisted commercial property and infrastructure continue to come out relatively well, reflecting their higher yields.
- Australian shares stack up well on the basis of yield, but it's still hard to beat Asian and emerging market shares for growth potential.
- The downside risks to the medium-term return projections are that: the world plunges into a recession driving another major bear market in shares or that investment yields are pushed up to more normal levels as inflation rebounds causing large capital losses. Just allow that drawdowns in returns tend to be infrequent but concentrated and it's been a while since the last big one.
- The upside risks are always less obvious, but could occur if global growth improves but inflation remains low.

Implications for Investors

- First, have reasonable return expectations. Low yields & constrained GDP growth indicate it's not reasonable to expect sustained double-digit or even high single digit returns. In fact, the trend decline in the rolling 10-year average of both nominal and real super fund returns since the 1990s indicates we have been in a lower-return world for many years – it's just that it only becomes clear every so often with bear markets and then strong returns in between.
- Second, remember that responding to a lower return potential from major asset classes by allocating more to growth assets does mean taking on more risk.
- Third, bear markets are painful, but they do push up the medium-term return potential of investment markets to higher levels and so provide opportunities for investors.
- Fourth, some of the decline in return potential reflects very low inflation – real returns haven't fallen as much.

- Focus on assets with decent sustainable income flow as they provide confidence regarding future returns.

Higher Income than Term Deposits

In the past, many investors have relied on interest income from Term Deposits, to satisfy some of their income needs. Unfortunately, the days of 5% and 6% interest returns are gone – you are lucky to get 1.5% now.

For those who:

- have significant Term Deposit investments
- are prepared to accept some volatility in returns
- are prepared to accept some capital risk, with only a low level of risk of permanent capital loss,

Retirewell has developed a diversified ’high income’ portfolio comprising 10 investments, with the opportunity to return a net 5% + per annum income, with some growth – but with no guarantees. Contact Retirewell for further information.

Finally, if the information conveyed in this Retirewell eNewsletter causes you any concern in relation to your own investment situation (particularly in terms of meeting your own personal or investment Goals and Objectives) please do not hesitate to contact us for a discussion or review.

Source: *Acknowledged to Shane Oliver, Head of Investment Strategy and Economics and Chief Economist at AMP Capital, from Investment Insight Report dated 29 September 2019, plus Retirewell internal research sources.*