The Rennie Quarterly Return

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Future Returns – Going Lower

What does the following string of numbers represent?

26.5•15.1•2.1•16.0•32.4•13.7

With all of the current Wall Street pessimism, it is easy to forget that they are the generous percent realized total rates of return of the S&P 500 Index, the US stock market if you will, from 2009 through 2014. After a nasty -37.0% decline in 2008, they are what you generally would expect in a market recovery. If you had invested $1,000 on 1/1/2009, you would have had $2,594 only six years later—unarguably pretty darn good.

So far this year, the best that can be said for the US stock market is that it has been volatile. No clear up or down trend has been established.

More interesting, however, is that market pundits have begun forecasting lower returns for all asset classes over the longer term, generally the next five to ten years. We tend to agree.

Pension funds are getting the message. They forecast the expected returns on their well-diversified portfolios so that their sponsoring companies or public entities know if annual contributions will be required to match liabilities, and if so, how much. Pension funds expect to earn 7.0% return this year, down from 9.1% in 1999—still a bit high in our opinion. A recent paper by BNY Mellon forecasts pension fund returns slightly under 6.0% over the next ten years.

The table below shows the annualized percent returns of various asset classes over the past 20 and 30 year periods ending December 2014.

	20	30
US Stocks	9.8	11.3
Foreign Stocks	5.2	8.7
Em Mkt Stocks	5.5	10.0*
US Bonds	6.2	7.4
REITs	11.1	9.5
Cash	2.9	4.2

* 27 years

Professional forecasts estimate that US stocks will earn an annualized return of between 6.5% and 7.0% over the next ten years, considerably lower than the numbers shown above. The rationale for this is that the US economy will grow slowly, and corporate earnings, the driver of stock prices, will also grow slowly. The forecasts also predict minimal differences in the returns on US and foreign stocks.

Long-term US bond return forecasts converge around the 3.0% level. This is not at all surprising given the current historically low interest rates. Such rates have only one way to go—higher, and with rising rates comes lower bond prices. The good news is that US bonds are not a homogeneous lot. Lower-quality (high-yield) bonds, for instance, have provided higher returns in the past; forecasts suggest that this will continue.

REIT forecasts look very much like US stock forecasts.

The bright spot in most forecasts is emerging markets, both stocks and bonds. The forecasts suggest that emerging market stocks will provide about 3.0% higher annual returns than US stocks. For emerging market bonds over US bonds, the return premium is forecast to be around 2.0%. All forecasts, however, come with the same caveat—emerging market returns will remain quite volatile.

One positive factor not considered in all forecasts is the value added by skillful fund managers. History suggests that there is a small group of active managers that can add additional return fairly consistently. For stocks, this is achievable but difficult. For bonds, we believe that this is also achievable but much less difficult.

So what is an investor to do given these forecasts of lower returns? Will a 1.0% or 2.0% reduction in total portfolio annual return really cause serious financial harm? We don't think so. As rational investors see the handwriting on the wall, they will make suitable adjustments. The world will go on pretty much unchanged.

One thing investors should not do is to reach for returns using unproven high-risk strategies. Many providers will promise higher returns with no historical evidence whatsoever. Such temptations should be avoided.

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Our Two

Politicians and diapers must be changed often and for the same reason.
Mark Twain

Quarterly Trivia:

About how many students at 347 predominantly for-profit colleges and vocational schools defaulted on their loans or failed to pay down even a single dollar on their debt after seven years?

More than 50% (source WSJ)