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THE
# Envestnet Edge
INSIGHTS FROM ENVESTNET | PMC

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## In a low-growth world, less could be more

*Investments are no longer generating the average annual returns that investors have become accustomed to for over the past 100 years, and people are rightly unsettled. But in a world in which there is lower growth, inflation, and costs, it is entirely reasonable to expect that annual returns might be lower, as well.*

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Step away from the intense bouts of volatility that recently have characterized financial markets, and an important trend emerges that is unsettling investors large and small. With few exceptions, investments simply are not generating the average annual returns that they've come to expect.

That reality has led to no dearth of handwringing, brow-furling, and expletive-laced protests. Last year, nearly every combination of investments (save for the Nasdaq domestically or Japanese equities internationally) either lost money or returned next to nothing. In spite of that fact, most investors continue to expect not just more than zero (a reasonable goal) but something approximating the returns they experienced for much of the latter decades of the 20th century. And that is not reasonable at all.

The world we are entering is messy and mysterious, but a few facts seem in order: it is a world of lower growth, lower inflation, lower returns, and lower costs. Some of these aspects may appear, at first glance, to be negative, e.g. lower growth. But those negatives are powerfully

offset by the positives of lower inflation and lower costs. Net net, therefore, this near future allows for decent *real* returns, even if the headline numbers are less gaudy.

What is imperative, however, is that investors of all stripes reset their expectations. Unless that happens, they are likely to be disappointed, disillusioned, and dismayed, and seek higher returns via investments that will carry more risk and may deliver less performance. It's neither a good combination, nor a necessary one.

**Figure 1:**
**IMF Global Growth Projections as of January 2016 (% change)**

| | Estimates | Projections | | Difference from October 2015 Projections | |
|---|---|---|---|---|---|
| | 2015 | 2016 | 2017 | 2016 | 2017 |
| **World Output** | 3.1 | 3.4 | 3.6 | –0.2 | –0.2 |
| **Advanced Economies** | 1.9 | 2.1 | 2.1 | –0.1 | –0.1 |
| United States | 2.5 | 2.6 | 2.6 | –0.2 | –0.2 |
| Euro Area | 1.5 | 1.7 | 1.7 | 0.1 | 0 |
| Germany | 1.5 | 1.7 | 1.7 | 0.1 | 0.2 |
| France | 1.1 | 1.3 | 1.5 | –0.2 | –0.1 |
| Italy | 0.8 | 1.3 | 1.2 | 0 | 0 |
| Spain | 3.2 | 2.7 | 2.3 | 0.2 | 0.1 |
| Japan | 0.6 | 1 | 0.3 | 0 | –0.1 |
| United Kingdom | 2.2 | 2.2 | 2.2 | 0 | 0 |
| Canada | 1.2 | 1.7 | 2.1 | 0 | –0.3 |
| Other Advanced Economies | 2.1 | 2.4 | 2.8 | –0.3 | –0.1 |
| **Emerging Market and Developing Economies** | 4 | 4.3 | 4.7 | –0.2 | –0.2 |
| Commonwealth of Independent States | –2.8 | 0 | 1.7 | –0.5 | –0.3 |
| Russia | –3.7 | –1.0 | 1 | –0.4 | 0 |
| Excluding Russia | –0.7 | 2.3 | 3.2 | –0.5 | –0.8 |
| Emerging and Developing Asia | 6.6 | 6.3 | 6.2 | –0.1 | –0.1 |
| China | 6.9 | 6.3 | 6 | 0 | 0 |
| India | 7.3 | 7.5 | 7.5 | 0 | 0 |
| ASEAN-5 | 4.7 | 4.8 | 5.1 | –0.1 | –0.2 |
| Emerging and Developing Europe | 3.4 | 3.1 | 3.4 | 0.1 | 0 |
| Latin America and the Caribbean | –0.3 | –0.3 | 1.6 | –1.1 | –0.7 |
| Brazil | –3.8 | –3.5 | 0 | –2.5 | –2.3 |
| Mexico | 2.5 | 2.6 | 2.9 | –0.2 | –0.2 |
| Middle East, North Africa, Afghanistan, and Pakistan | 2.5 | 3.6 | 3.6 | –0.3 | –0.5 |
| Saudi Arabia | 3.4 | 1.2 | 1.9 | –1.0 | –1.0 |
| Sub-Saharan Africa | 3.5 | 4 | 4.7 | –0.3 | –0.2 |
| Nigeria | 3 | 4.1 | 4.2 | –0.2 | –0.3 |
| South Africa | 1.3 | 0.7 | 1.8 | –0.6 | –0.3 |

Source: IMF, World Economic Outlook Update, January 2016.

## The past is not prologue

For the 100 years between 1915 and 2015, the S&P 500 averaged nearly 10% annual returns. And it is fair to say that a vast number of investors, ranging from day traders to sober institutional managers, continue to use that number as a fair target. Since the early 1980s, bonds have returned more than 8% annually to investors. That alone explains why similar assumptions about the next decades persist, and why return expectations were set at those levels.

Those expectations matter, especially for large pension plans. Although there are fewer corporate defined benefit plans today than existed in the late 20th century, there are still trillions of dollars in public plans and endowments.

But today's world has shifted into a decidedly different growth trajectory. Growth remains relatively strong in the developing world, but is distinctly slower than it was from 2000-2013, dipping under 5% this year. Growth in the United States, the Eurozone, and Japan, which at about $40 trillion still make up more than half of global output, has slowed to less than 2.5%. Global interest rates are almost everywhere in decline, with sovereign yields in the developed world (which make up the bulk of issuance) well under 2%, and in many cases, under 1%. In addition, inflation is almost everywhere in the developed world non-existent, well below 2%, and fading in the developing world as well, including China.

Companies have, it is true, continued to generate profits well in excess of global growth, though that too may be shifting. For now, overall profit growth of the S&P 500 is flat to down because of the implosion of energy and commodity corporate earnings, and it is too soon to tell whether that collapse will spread chronically to other sectors. Regardless, the overall rate of annual corporate earnings growth could well be declining from double digits to high single digits.

That is the world now. The problem is that return expectations are not grounded in the world of today—they are lodged in yesterday.

Over the past decade, the return assumptions of state and local pension plans have indeed come down—by a whopping 37 basis points, from just over 8% in 2001 to 7.68% at last report (Figure 2). Plans are resetting their expectations downwards,

but at the glacial pace that one would expect from large institutions. And that pace is far too slow in a world that is changing far too fast. A move of less than half a percent is, at the very least, not much, given how much the growth profile of the world has shifted.

And yes, some select endowments, especially university funds such as the famed Yale endowment, have continued to generate gaudy double-digit returns based on a heavy exposure to alternative and direct investments in hedge funds, private equity, and real assets (Figure 3). Even here, however, the trend line has been down: returns are still well above market returns, but the gap is closing.

It is, of course, quite possible that the world will shift back into a higher-return profile at some point. It also is possible that the many critics of the current environment are correct: that it is a product of overly loose central banks that are artificially distorting price signals and keeping rates and returns low. Both are possible, but may not be probable.

In the face of what we know—that growth is slowing and prices are dropping—juxtaposed against the uncertainty about that which we do not, it would be prudent to lower our expectations. The advantage of doing so is that rather than reaching for returns that can only be achieved by assuming more risk or more margin and more exposure, we accept a lower threshold. If that threshold is met, great, and if it is surpassed, even better, but it then will be surpassed not because of assuming excessive risk but because of stronger markets and their underlying fundamentals.

## The silver lining, and a very shiny one it is

If this were a call just to deal with it and accept lower returns, that would be cold gruel. But there is a silver lining here, and not an insubstantial one: this lower returns world is unfolding in a time in which costs are plunging, inflation is tepid, and interest rates (hence the cost of capital) are incredibly low.

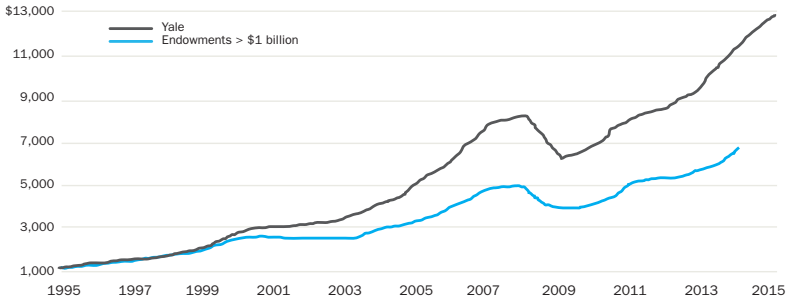
Those years when the average returns were 8%, 9%, 10% were by and large years when inflation was 4%, 5%, or in the 1970s, 10% or more. They were years when interest rates averaged 5% or 6% or again even more, on average, and that made the cost of capital, and thus doing business or buying

**Figure 2:**
**Public pension fund managers are only slowly lowering return expectations**

| State/local pension investment return assumptions vs. 10-yr Treasury yield | | | |
|---|---|---|---|
| Fiscal Year | Assumed return | 10-yr Treasury yield | Assumed risk premium |
| 2001 | 8.05% | 5.02% | 3.03% |
| 2002 | 8.04% | 4.61% | 3.43% |
| 2003 | 8.00% | 4.01% | 3.99% |
| 2004 | 7.98% | 4.27% | 3.71% |
| 2005 | 7.96% | 4.29% | 3.67% |
| 2006 | 7.95% | 4.80% | 3.15% |
| 2007 | 7.94% | 4.63% | 3.31% |
| 2008 | 7.95% | 3.66% | 4.29% |
| 2009 | 7.91% | 3.26% | 4.65% |
| 2010 | 7.87% | 3.22% | 4.65% |
| 2011 | 7.78% | 2.78% | 5.00% |
| 2012 | 7.72% | 1.80% | 5.92% |
| 2013 | 7.68% | 2.35% | 5.33% |

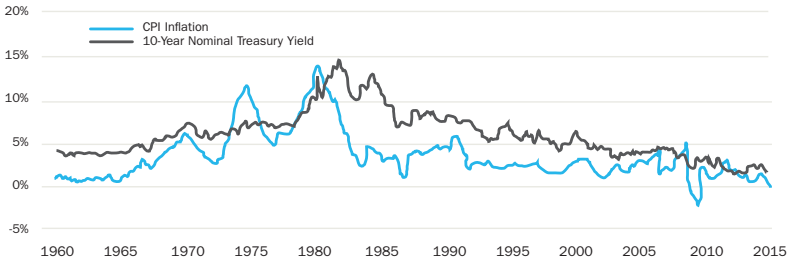
Source: "Public Pensions Lower Return Assumptions, But Taking More Risk", Andrew Biggs on Forbes.com. Author's calculations from Public Plans Database and U.S. Treasury data.

**Figure 3:**
**Yale and other endowment returns, 1995-2015**




Source: Bloomberg via Annual endowment reports, NACUBO-Commonfund Study of Endowments

**Figure 4:**
**U.S. interest rates and inflation, 1960-2015**




Source: Brookings.com, via Federal Reserve Board, BLS

a home, much dearer. In short, for much of that time the positive effects of high returns were offset by the negative effects of rising inflation and high interest rates. High rates did generate more yield for investors, but that higher yield then was offset by higher real world costs (Figure 4).

In that sense, lower returns today can have the same net effect as higher returns did for thirty years. It is the same principle as "real income," which adjusts for costs. Today's 5%, therefore, may seem paltry compared to yesteryear's 10%, but that is only because we so often fail to integrate the larger context, which must include inflation, costs, and interest rates. This "new normal" of lower returns may feel like a comedown, but that is because returns are being analyzed in an abstract vacuum, when instead they should be evaluated within the context of those other variables.

Less may not feel as good as more does in a culture that has been primed to expect more. But in the world we are entering, lower returns may be just as tenable and add as much value as higher returns did in an earlier time. At a minimum, it is a conversation we need to have, and a debate that demands more attention. ■

**February Take-Away:**

For many decades, the S&P averaged 10% annual returns while bonds averaged 8%. In today's world, lower growth, lower inflation, lower costs, and lower corporate earnings all translate to lower returns. But this "new normal" has a silver lining: lower returns are juxtaposed against lower inflation, costs, and interest rates, making it less expensive to do business or buy a home. Rather than succumb to the temptation to assume more risk to chase higher returns, prudent investors will recognize that in today's world, lower returns can add just as much value as higher returns did in yesteryear. They will want to realign their return expectations in the context of the world we live in today.

## About Envestnet®

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