Investment Returns: What's in Store for the Next Decade?

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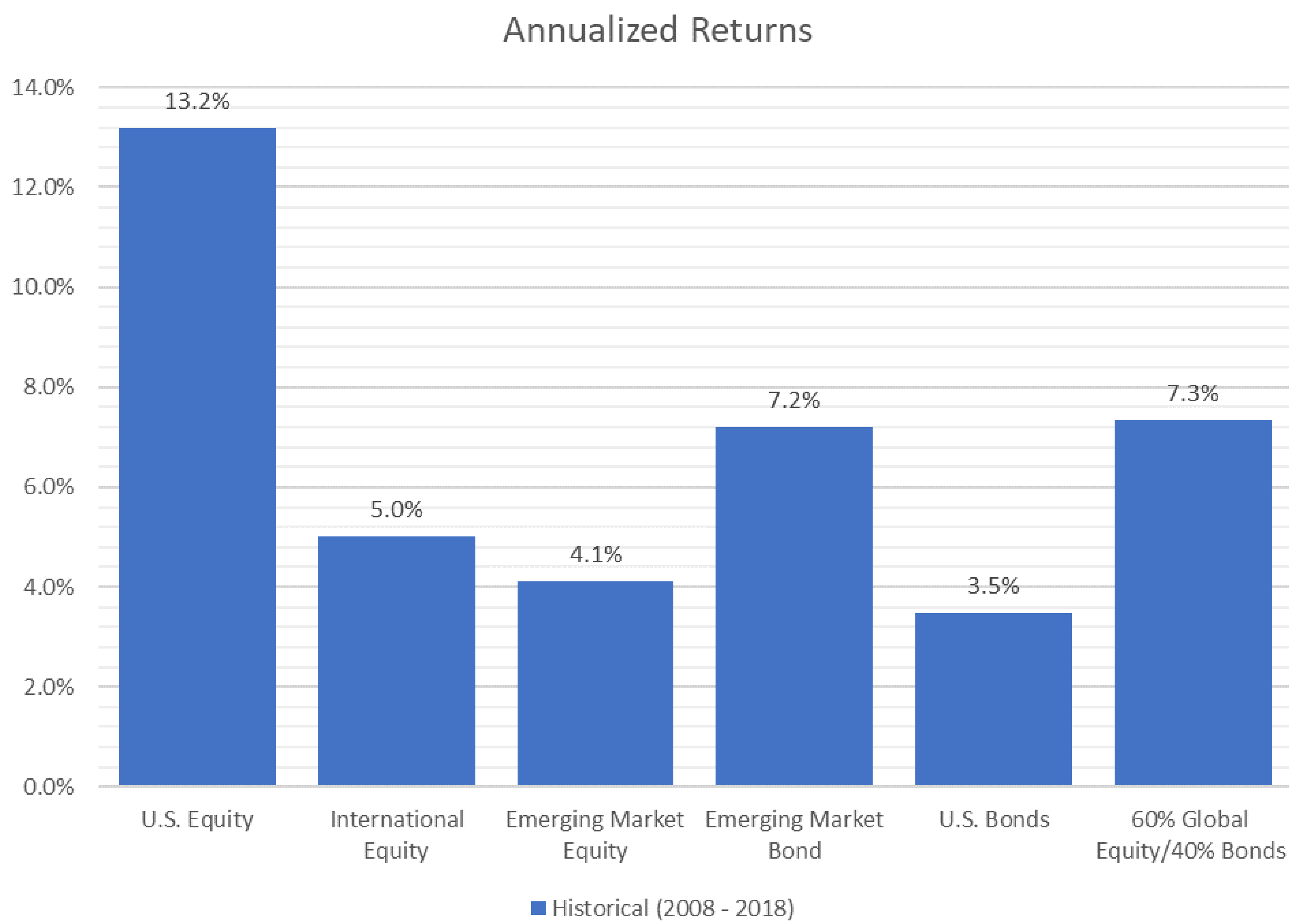
When developing financial plans for our clients in or nearing retirement, we assume that their portfolios will grow by 5.0% annually over the long-run, after all fees. For younger clients, we assume a 6.0% rate of return, as younger clients typically opt for more equity-rich portfolios given their longer time horizon. We view these to be conservative projections, but are they reasonable?

At first glance, these rates of return may seem overly conservative. As most of you know, the last decade has been kind to stock market investors (as shown in Figure 1). Our assumptions seem particularly low for those heavily invested in the U.S. stock market, which now represents over half of the value of all stock markets around the world.

The U.S. market has outperformed in part because the U.S. Federal Reserve was much more proactive in stimulating the U.S. economy after the 2008 financial crisis. In contrast, policymakers in Europe, in particular, were slower to move with both fiscal and monetary stimulus and have been beset with various crises over the period (e.g. the two euro crises, Greece bailout, Brexit). In addition, U.S. technology stocks, which are a larger share of the overall U.S. market than in Europe, has had a phenomenal decade as technological innovation accelerated. Conversely, the decade has been less than kind to bond returns. Even still, a globally-balanced portfolio (i.e., 60% equity and 40% bonds) earned 7.3% on average, and higher still for those willing to put more than 60% into equities.

However, when investing, looking in the rear-view mirror can be misleading as the future rarely repeats the past. The real question to ask is what exactly drives expected stock market returns? Most experts will tell you that what matters most is how expensive or cheap the stock market is at the beginning of the forecast period, and what corporate earnings are expected to be over the forecasted time frame. Starting values matter because stock markets have a tendency to "revert to the mean" meaning that a period of outperformance is typically followed by a period of underperformance (to get back to the mean) and vice-versa. Projected corporate earnings matter because as earnings increase, investors

Figure 1. Selected Historical Market Returns: 2008-2018



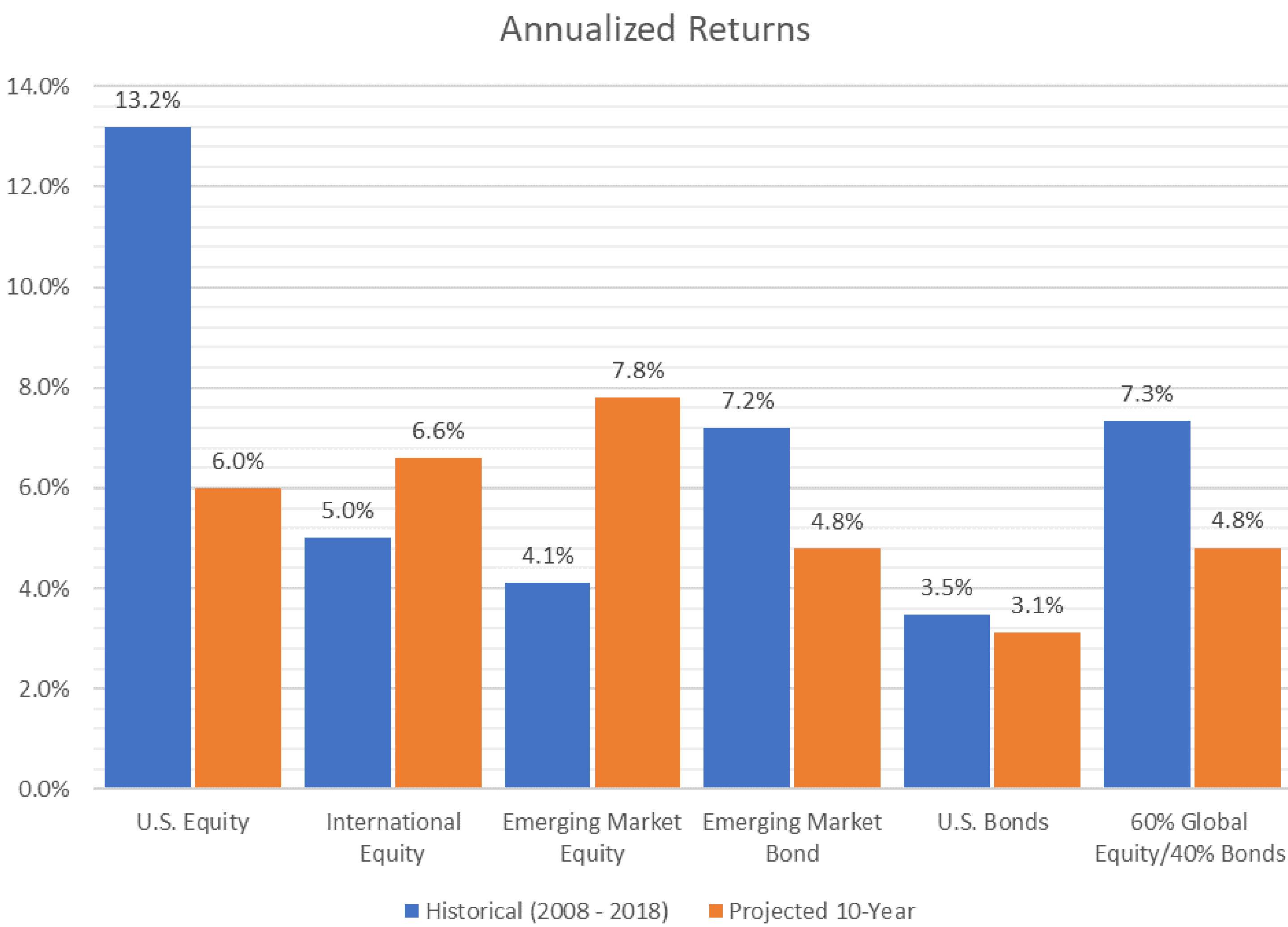
are willing to pay higher prices to gain access to the enhanced earnings stream.

Many leading financial institutions and research houses periodically update their in-house forecasts of various capital market returns, typically over an 8-10 year horizon. We recently compiled and averaged the views of a handful of these firms and then compared these findings to the actual returns over the last decade. These figures are shown below.

As shown, the 60/40 portfolio is expected to return 4.8%, before taxes and fees over the next decade, over a 30% haircut from its historical return.[1] There is also an apparent shift away from U.S. equities and toward international equities. Much of this is based on the fact that the U.S. market is currently more fully valued (i.e., expensive) than its international counterparts. Lower projected returns are also due to the fact that bond yields are expected to be lower on average over the next decade relative to the last decade, for reasons that go beyond the scope of this note.

[1] Of note, however is that most of these firms are forecasting inflation to be 2.1% on average over the decade, whereas our models assume 2.5%.

Figure 2. Historical versus Projected Market Returns



Source: BNY Mellon, Envestnet, J.P.Morgan, BlackRock, Research Affiliates

Bottom Line:

Nobody knows for sure what the future will bring; however, our 5.0% return for a 60/40 portfolio is not as conservative as we thought. Let's hope we are wrong!

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