Financial Market Returns: Time for a Reality Check

For investors and savers, today’s financial environment must rank among the least rewarding in half a century, if not longer. In the major advanced economies – the US, Canada, Japan, the UK, and most of continental Europe – the “policy” interest rates set by central banks are at or near all-time lows. This translates into almost non-existent returns for savers who squirrel away money in bank accounts, GICs, and money market funds.

The same is true for the buyers of government bonds – ten-year government bond yields in Canada and the US now hover under 2 percent. With inflation projected to be at or above 2 percent, this means investors in government bonds who hold to maturity are on track for negative real (that is, after-inflation) returns. Despite this counterintuitive picture, there is no lack of demand for the sovereign debt of credit-worthy issuers.

Far from being a positive sign, the peculiar behavior of the bond market reflects gloom about the prospects for the global economy. While ten-year government bonds may promise negative real returns, many investors judge them a better option than traditionally riskier asset classes, notably equities. And equities are indeed risky, as evidenced by a decade or more of negative cumulative returns across most developed country markets. Yet when interest rates rise – as eventually they must – bond-heavy portfolios will be hammered (interest rates and bond prices move in opposite directions).

Does it follow, then, that stocks are the wise choice for nervous investors? Economists have tended to believe that, over the long haul, equities should outperform bonds. Because stocks typically carry more risk than bonds, the returns for holding them should be higher; this is often referred to as the “equity risk premium.” If one adopts a sufficiently long-term perspective, the data show that stocks have, in fact, done better. But it’s increasingly clear that the definition of “long term” can test the staying power of even patient investors. Indeed, government bonds have actually produced higher cumulative returns than stocks over the past 25-30 years, despite being a much safer asset class. This result runs contrary to the expectations generated by finance theory.

Today, the broad equity market indexes in many advanced countries are trading below their levels of 10, 15 or – in the case of Japan – 20 years ago. In Canada, the TSX index is approximately one-fifth below where it stood in the summer of 2008. How long before the benchmark Canadian index punches through the 15,000 level set a little more than four years ago? No one knows. In the meantime, stocks could easily fall another 10-15 percent, amid a struggling global economy and faltering growth here in North America.
In part, the outperformance of bonds versus stocks can be explained by a long secular decline in interest rates (and inflation) since the 1980s, which served to boost fixed income returns. With interest rates currently plumbing the depths, it’s hard to conjure up a scenario of rising bond prices going forward. The end of the long bond bull market may cause investors to look more fondly on equities.

Yet consider what the “smart money” is doing. Many of Canada’s largest public pension funds – the Canadian Pension Plan Investment Board, the BC Investment Management Corporation, and the Ontario Teachers’ Pension Plan, to name just three – are shifting capital away from publicly traded securities (stocks as well as bonds) and toward “alternative” assets like real estate, infrastructure, and private equity. To some extent this reflects prudent portfolio diversification. But it also speaks to a belief by these sophisticated money managers that the returns on publicly traded securities are apt to disappoint in the years to come.

In a slow growth world where many advanced economies are burdened with both excessive debts and unfavorable demographics, it makes sense to scale back expectations for financial market returns. Instead of the 8 percent annual returns targeted by many fund managers prior to the 2008-09 financial crisis, something closer to 5-6 percent seems reasonable. This assumes a portfolio mix of 30-40 percent fixed income, 50-60 percent equities, and 10 percent cash, gold and other alternative assets. Some market-watchers judge even 5-6 percent to be optimistic. Legendary US money manager Bill Gross, for one, recently speculated that nominal returns of 3-4 percent may become the new normal. Gross has also announced the “death” of what he calls “the cult of equities.”

Of interest, the Canadian Pension Plan Investment Board (CPPIB) has set a real return objective of 4 percent per year, which after inflation amounts to roughly a 6 percent nominal return. Given its extensive resources, unrivalled access to investment opportunities, and ability to minimize costs and fees, the CPPIB is likely to outperform most other institutional money managers. If the CPPIB is correct in its assessment of economic and financial market prospects, even returns of 5-6 percent may be out of reach for the rest of us.