Managing Through a Low Return Environment: How Expected Returns Influence our Asset Allocation

At MAI, the cornerstone of our investment philosophy is understanding each client's unique goals and objectives and then developing a strategy that has the greatest odds of helping our clients achieve success. We believe understanding the future return outlook is an important part of this process and can help us more efficiently construct each client's portfolio to meet their short and long-term goals. Historically, U.S. equity returns have averaged 10% annually (data back to 1926 including dividends) while U.S. bonds have delivered 5% (10-year treasury data 1962-present). Today, we find ourselves in an environment where the 10-year outlook for U.S. equity and bond returns could be roughly half of historical averages. This Insights piece will examine the drivers of long-term returns and how we are managing client portfolios for this potential low-return environment.

Since we know the current 10-year return for a U.S. Treasury bond is 3.0%, we will focus our time on our expectations for the U.S. equity market. While many factors such as interest rates, inflation, and economic growth can impact market returns, the profitability of companies ultimately drives the stock market over the long-term. From 1960-2017, S&P 500 earnings rose at a compound rate of 6.7% per year. Add in the average dividend of 3.0% and we arrive at the long-term equity rate of return of roughly 10% per year. However, 10-year returns within this historical period varied greatly depending on beginning valuation and growth in earnings - two factors that deserve our attention in forecasting future returns.

Beginning Valuation Influences Long-Term Returns

First, we will look at the impact of starting valuation on market returns. All else being equal, the higher the starting valuation of the market, the lower the future expected return. In other words, investing into the S&P 500 at a price-to-earnings (P/E) multiple of 20x earnings is less attractive than investing at 10x earnings. The current starting P/E multiple for the S&P 500 is 16.8x earnings, which we believe is a slight premium to where the market will normalize to over time (around 15x earnings). Other valuation metrics such as the price-to-*sales* multiple appear even more expensive today because companies have expanded their profit margins to all-time high levels. The market's premium valuation today is likely to cause a reduction in future returns.

Earnings Growth is also Critical to Long-Term Returns

The second driver of returns we will look at is earnings growth. From 2012 to 2017, earnings grew 4.8% per year, falling short of the historical average of 6.7% despite record low interest rates and accommodative monetary policy. Following tax reform at the end of 2017, earnings growth accelerated with consensus estimates calling for 22% growth in 2018 and 10% growth in 2019. Unfortunately, this is likely to be a one-time boost rather than the start of a new trend. With monetary policy becoming tighter (expectations are for additional Fed Funds Rate hikes in 2018 and 2019), wage pressures rising, and GDP growth on a slower long-term trend, we believe the headwinds for earnings growth outweigh the tailwinds and that future earnings growth is likely to be below the long-term average over the next 10 years.

MAI Expects Lower than Historical Returns Over the Next 10 Years

With above-average starting valuations and below-average projected earnings growth, we expect returns to be lower than historical levels over the next 10 years. Our base case forecast calls for 5% earnings growth, a 2.0% dividend yield, and a slight multiple correction to 15x earnings at the end of the period. As shown in the shaded column below, this combination would produce a 10-year total return of 5.8% annually. The other cases shown below assume different ending valuation multiples, with expected returns ranging from 1.6%-8.9% per year.

Base Case: 5% earnings growth and slight multiple correction

Today's P/E	16.8	16.8	16.8	16.8	16.8
Earnings Growth	5.0%	5.0%	5.0%	5.0%	5.0%
Dividend Yield	2.0%	2.0%	2.0%	2.0%	2.0%
Ending P/E	10.0	12.5	15.0	17.5	20.0
10-Year Return	**1.6%**	**3.9%**	**5.8%**	**7.4%**	**8.9%**

Source: Factset

Portfolio Strategy: Staying Invested is Still the Best Option

Despite expectations for more modest returns going forward, our view is that it still pays to be invested. Regardless of starting valuations, investors who stayed invested through the ups and downs of the markets have historically enjoyed the benefits of positive compounded returns in stocks, bonds, and diversified portfolios. Since 1950 there has never been a 20-year period where stocks, bonds, or a blended 50/50 portfolio have produced negative annualized returns. While past performance is no guarantee of future similar results, we believe taking broadly diversified market risks through a long-term strategic allocation remains the best strategy for preserving wealth and purchasing power.

While staying invested and reacting productively to corrections are often the primary drivers of long-term investment success, at the margin, we continue to advocate complementing traditional portfolios of U.S. stocks and bonds with other opportunities that appear cheaper and/or uncorrelated to these more expensive market segments. For example, within equities, we have slightly increased our exposure to international stocks following years of underperformance versus U.S. markets. Although these markets generally move in tandem with the U.S. in the short run, the combination of cheaper valuations and promising growth outlooks should result in stronger relative returns over time. Within fixed income, we are paying close attention to the risk of rising interest rates and we do not believe extending duration is the best way to achieve returns. Outside of equities and fixed income, we continue to see an attractive premium for sacrificing some liquidity to invest in asset classes like private real estate, private credit, reinsurance, and other income-producing alternatives. While not without risk, we believe these strategies can complement traditional stock/bond portfolios in areas where they are currently challenged - both from a total return and income generation standpoint.

As always, we appreciate the confidence you have placed in MAI to be your trusted advisor. If you have any questions regarding your portfolio or would like to discuss any changes in your financial situation, please feel free to contact us at any time.