

# Low return world ten years on – what does it mean for investing?

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## Key points

- > We have now been in a low return investment world for more than a decade globally.
- > While the US long term or secular bear market in shares that started in 2000 is getting 'long in the tooth' and showing some positive signs, it could linger for a few years more. Valuation measures could still move to secular bear market extremes and debt reduction, ageing populations and less business friendly governments are all likely to constrain growth.
- > For investors, particularly those with a shorter term horizon, this highlights the importance of paying more attention to asset allocation and to considering investment strategies that target particular outcomes (eg, a particular income flow or a targeted rate of return).

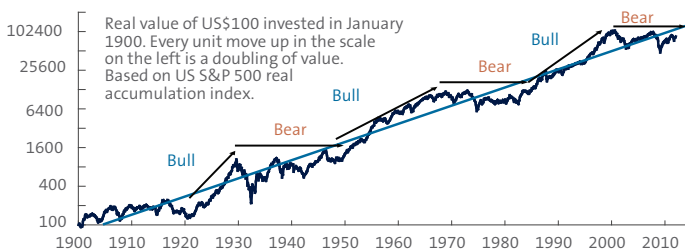
## Introduction

A decade has now passed since I first wrote a note suggesting that we are coming into an environment of low and volatile investment returns.<sup>1</sup> At the time, I and various investment strategists were concerned the drivers of the super normal returns from most asset classes from the early 1980s had largely run their course and therefore, sustainable returns would revert to longer term norms. While a high return world lingered for Australian-based investors up until 2007 (thanks to a strong performance by the Australian share market during the first mining boom), low sub-par medium term returns have been a phenomenon for US and European investors for the last decade and even longer for Japanese investors. This all begs several questions – if the low return world is more than a decade old is it nearly over? If not, what does it mean for the way we manage money?

## The secular ebb and flow of shares

It should be well known that share markets go through longer term secular bull and bear phases. This is most clearly evident in the US share market (which of course sets the direction for global shares) and illustrated by the following chart, one of my favourites. It shows the cumulative real value of \$100 invested in 1900.

### Long term bull and bear phases in US shares



Source: Global Financial Data, AMP Capital

Secular bull markets, or 10 to 20-year periods where the trend in shares is up, can be seen in the 1920s, 1950s and 60s, and the 1980s and 90s. In between in the 1930s and 40s, 1970s and over the past decade are secular bear markets which are longer term periods where shares have poor and volatile returns.

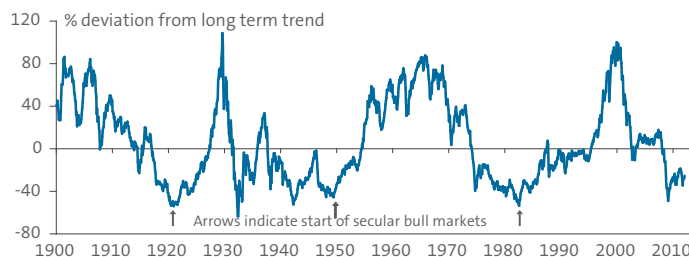
These secular bull and bear phases are driven by a combination of the macro environment and related long waves of innovation, periods of excess in the provision of credit and long term swings in market valuations. In summary;

- > The 1920s bull market was associated with electricity, mass production and easy credit. The good times ended when markets became overvalued and the world slipped into depression.
- > Cheap valuations, post war consumerism, petrochemicals, electronics, aviation and low inflation underpinned the secular bull market of the 1950s and 60s.
- > By the late 1960s shares had become overvalued again. This, in combination with rising inflation, poor economic management and oil shocks, gave way to a secular bear market in the 1970s.
- > This set the scene for the secular bull market of the 1980s and 1990s, which started when shares became very cheap in 1982. Share market growth was underpinned by the shift to low inflation, deregulation, globalisation, the peace dividend and ultimately, the technological revolution.
- > By the turn of the last century, shares had become expensive again and the 'tech wreck', corporate governance scandals, a bursting of credit and various housing bubbles and public debt concerns have all underpinned a secular bear market in US and European shares since 2000.

## Where are we in the current secular bear market?

The first thing to note is the current secular bear market is getting quite long, running at 12 years, whereas the norm is 10 to 20 years. Furthermore, there are some signs of light in the direction setting of the US. Cumulative real returns from US shares have now fallen well below their long term trend and are running around levels associated with the start of secular bull markets in 1920, 1949 and 1982.

### US shares – cumulative real return index – deviation from trend



Source: Global Financial Data, AMP Capital

Furthermore, the US manufacturing sector seems to be staging some sort of renaissance, with numerous companies opening plants or expanding production capacity.

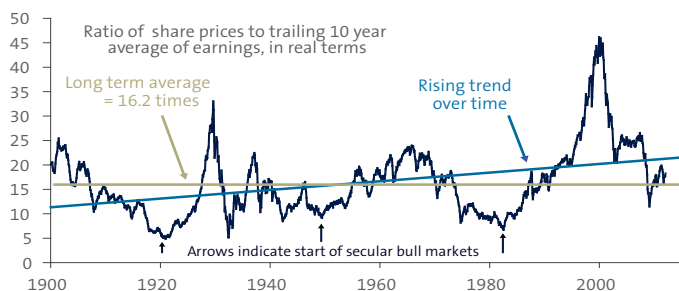
While there are some positive signs and the current secular bear market in global shares may be 'long in the tooth', our assessment is it could still have some way to run for the following reasons:

- > The message from valuation indicators is mixed. US shares are cheap compared to the history of the past 20 or 30 years and are particularly cheap compared to bonds, which are offering yields at or around record lows. This is all consistent with more gains in the current cyclical upswing. Against this though, the so-called Graham Dodd or Robert Shiller Price-Earnings ratio calculation, which measures shares against a 10 year moving average of earnings to

1 See "Living in a low return world", Oliver's Insights, February 2002.

smooth out cyclical fluctuations, shows the excesses of the 1990s have been unwound, but the market remains above its long term average and only slightly below its long term rising trend. This is fine, but mean reversion often sees shares go well into cheap territory before the next long term bull market gets underway.

### US shares are around their long term average price-earnings ratio



Source: AMP Capital

- > Private sector deleveraging has some way to go and the credit environment is likely to remain tough post GFC. Following financial crises, countries typically see many years of constrained economic growth and greater volatility before the situation improves.
- > High public debt levels in the US, Europe and Japan have left them with little fiscal fire power to respond to future economic downturns and ongoing pressure to cut budget deficits. As such, fiscal austerity will be a constraining factor for growth.
- > Monetary policy settings are extremely accommodating, providing a source of potential future volatility when they have to be reversed.
- > Social unrest is rising and economic policy is becoming more populist and interventionist, which is likely to be bad for productivity, in contrast to the economic rationalist policies of Thatcher, Reagan and Hawke/Keating introduced in the 1980s that coincided with the start of the last secular bull market.
- > Demographic trends have become less favourable with the proportion of the population in developed countries at peak spending age now declining and baby boomers starting to retire and focusing on capital preservation.
- > The greater global reliance on growth in the emerging world could add to volatility as emerging countries are inherently more volatile.

### What does this mean for markets?

If the secular bear has a bit further to run it has several implications for investment markets.

- > First, average medium term returns are likely to remain constrained. The following table shows our medium term return projections for key assets classes. For a diversified growth mix they imply single digit returns around 8% pa.

#### Projected medium term returns, %pa, pre fees & taxes

	Current Yield (%)#	+ Growth (%)	= Return (%)
Global equities (local currency)	2.6	4.3	6.9
Asia ex Japan equities	2.3	8.0	10.3
Emerging equities	2.6	7.0	9.6
Australian equities	4.7 (6.1*)	5.2	9.9 (11.3*)
Unlisted commercial property	7.0	2.5	9.5

	Current Yield (%)#	+ Growth (%)	= Return (%)
Unlisted commercial property	7.0	2.5	9.5
Australian REITs	6.1	2.5	8.6
Global REITs	5.5^	3.3	8.8
Unlisted infrastructure	6.0	4.0	10.0
Global listed infrastructure	5.0^	4.0	9.0
Australian government bonds	3.8	0.0	3.8
Australian corporate debt	6.5	0.0	6.5
Australian cash	4.3	0.0	4.3
Diversified growth mix			8.0

# Current dividend yield for shares, distribution/net rental yields for property and 5 year bond yield for bonds. ^ Assumes an average contribution of 2%pa from hedging foreign currency exposure. \* With franking credits added in. Source: AMP Capital Investors

- > Second, volatility is likely to remain high reflecting the fragile nature of the recoveries in the US and Europe, extreme settings in monetary policy and more fickle investors following the GFC experience.
- > Third, the fragile nature of the global economic recovery combined with investor nervousness means the phenomenon of 'risk on/risk off' is likely to remain a key feature. This means all risk or growth-related assets – share markets, credit, commodities, emerging market and commodity currencies, trade as a bloc. In this sense, we are either in "risk on" or "risk off" mode and the relative merits of each asset or security in the growth bloc are of lesser importance.
- > Fourth, the fragile macroeconomic backdrop means economic and financial events are likely to dominate microeconomic and more company specific news.
- > Finally, the increased volatility and investor nervousness probably means fair value price to earnings multiples on shares may be two points or so lower than over the last decade or two, say 13 times for Australian shares rather than 14.5 times. In other words, investors are demanding a higher risk premium.

### What does it mean for investors?

Lingering shifts in the longer term macro economic and investment background have invariably led to change in the way investment funds are managed. This is no less the case now. Key things for investors to be aware of are as follows:

- > Even in secular bear markets there is a cycle. Don't despair after sharp falls as opportunities arise from lower asset prices.
- > Asset allocation is paramount to driving returns in the current environment, well above the potential impact of manager and stock selection.
- > Focus on markets less constrained by negative secular forces, eg. the emerging world, corporate debt, commercial property and infrastructure.
- > Focus on investments providing a decent income flow as it provides confidence regarding returns, eg. corporate debt, commercial property, infrastructure and quality high-yielding Australian shares.
- > For those with a short term horizon or specific needs, consider investment strategies that target an investment outcome such as income yield or a return target.

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