HEARD FROM CLIENTS

FINDING RETURNS IN A CHANGING INVESTMENT LANDSCAPE

After years of working with clients, we've seen that many families share similar questions and concerns. Hearing these questions from clients, we imagine there are others with the same concerns who just haven't had the opportunity to ask.

Every quarter we will answer a question. Sometimes the questions we cover will be timeless: how do I talk to my children about our wealth? Sometimes they will be current: how will the new administration affect my taxes? Every time, they will be inspired by our clients.

YOUR QUESTION

For decades, my portfolio has performed well, but I'm seeing changes here and abroad. Can I expect strong returns to continue? What do I need to do in order to continue to protect and grow my portfolio?

OUR THOUGHTS

Investors have enjoyed 30 years of strong tailwinds guiding their investment portfolios to relatively strong returns. The four key drivers primarily responsible for creating these tailwinds, however, are in the process of slowing, potentially altering the investments landscape for the next several decades in significant ways. But before taking a look at the future, it is important to review the past, focusing on these key drivers that have impacted the investment landscape for the past three decades.

DELEGATE ADVISORS

A 30-Year Retrospective

The past 30 years were notable due to four key drivers of the global economy and investment landscape. The first of these key drivers has been the prolonged and significant decline in **interest rates**, which plummeted across all maturities by double digits from 1981 to 2016. This decline has resulted in:

- High total return from bonds resulting primarily from price appreciation (as interest rates fall, bond prices rise)
- Reduced corporate borrowing costs (lower cost of debt)
- Higher corporate profitability (companies book a lower interest expense)
- Increased valuation of virtually all financial assets (as the discount rate falls, asset prices rise)

With interest rates at or near historical lows, the probability of the prolonged decline in rates continuing into the future is low. Rates may remain low for an extended period of time or may begin to rise, but another 30-year decline is not likely to occur.

The second key driver has been **globalization**, which has led to an increasingly free flow of capital across international borders. Notable treaties and agreements, including the creation of the World Trade Organization, the signing of NAFTA, and establishment of the Eurozone, have all contributed to the burgeoning globalization of the past 30 years. Geopolitical events such as the fall of communism (including the breakup of the USSR and the opening and privatization of Russia) and the opening and expansion of trade with China have also contributed to the globalization of trade.

However, several key factors are now leading the world away from globalization and potentially toward a nationalism marked by individual countries focusing on issues within their borders. "Brexit" and the election of President Donald Trump are clear exzamples of this emerging trend. Another area to watch is the potential disintegration of OPEC. This global shift towards the restriction of capital flows will likely have a dampening effect on global growth in the coming decades.

Favorable demographic trends have been the third key driver. The dramatically increased United States birth rate following World War II created a generation of individuals and families that began to enter the savings and investment phase of life almost thirty years ago. This "tidal wave" of baby boomers has created an unprecedented demand for financial assets (i.e., stocks and bonds) since the mid-1980s, which, in turn, has put consistent upward pressure on asset prices.

Demographic trends are notably different today; in many cases the children of baby boomers are earning less than their parents earned and are unable to save or invest. And with the graying of America, age distribution is skewing older than it did 30 years ago. The result? Baby boomers are not being quickly replaced as they "age out" of the economy, negatively impacting savings and investments, thus reducing the demand for financial assets. This change in demographics marks a slowing tailwind driving the economy. In 1985, baby boomers were 20-40 years old; today, they are 52-72.

By the way, this is not a strictly American phenomenon. The same thing is happening in many developed economies, including the major economy of Japan, potentially to an even greater extreme.

The fourth key driver has been the creation and explosive growth of the **Internet**. Noteworthy for causing advances in productivity and efficiency, the Internet contributed substantially to the global economic growth of the last thirty years. For example, the volume of domestic e-commerce has increased at a 17% annual rate since 2000. Because the Internet has permeated commerce substantially, the greatest productivity increases generated by the Internet are likely behind us. The big question is what will ultimately take its place, if anything.

The Next 30 Years

Looking ahead, the key economic drivers of the last 30 years will most assuredly not drive the next 30. In the very short term, the US economy may disappoint as the "election high" wears off. In the following few years, the economy may be stimulated by more money entering the system through fiscal stimulus, including tax cuts and greater spending. However, challenges are in the offing, including difficulty achieving a nominal 5-7% return in a potentially low-return environment. Sophisticated portfolios will likely need to include alternative investments to meet or exceed return targets; that said, in the case of one type of alternative, private equity, high entry valuations and excessive "dry powder" may dampen returns. Opportunities in secondary and distressed markets (such as energy) may arise, in special situations in disruptive technologies.

Alternatives to Drive Returns

Coming back to the original question, overall, the 60% stock /40% bond portfolio that has worked so well over the past 30 years will likely not result in similarly high returns over the next 30. Families who spend very little may simply be able to accept low returns for an extended period of time. Families who are either unable or unwilling to accept low returns likely need to take steps now to put themselves in a position to a) opportunistically allocate around market dislocations and b) strategically allocate to private assets.

There will likely be periods of time wherein marketable assets are mispriced, thus providing opportunistic investors the potential to earn relatively high risk-adjusted returns. To really take advantage of these opportunities, investors need a team that spends time carefully examining the fundamentals of each asset class from the ground up. Investors would also benefit from the ablilty to be flexible, moving quickly into mispriced markets. Finally, investors need the conviction to buy when others are selling. Warren Buffet put it best:

"Be fearful when others are greedy and greedy when others are fearful."

In addition, families should consider allocating capital to private assets. This requires accepting material illiquidity risk in order potentially to achieve a better risk-return profile relative to public markets. Along these lines, there are opportunities for investors in private debt, later-stage private equity, secondary private equity and private real estate. Accessing these opportunities generally requires strong due diligence focused on finding and analyzing managers that have a demonstrated ability within a certain space. If an investor or a trusted partner is able to put the time and resources into identifying interesting private opportunities, the returns realized from these investments could outpace the public markets in the years to come.