Adjusting expectations for a lower return world

Returns from assets ranging from shares to bonds, real estate, private equity and infrastructure have been very strong over the past decade. Low interest rates in developed countries have meant that cash is just about the only significant asset class to have missed out on the return feast.

Despite the period of upbeat returns, there has been increasing investment industry commentary on preparing investors for lower future returns.

Frontier Advisors noted that one-quarter of MySuper funds had reduced their investment return goals during the last three years.[1] Rice Warner recently commented that superannuation funds "ought to be preparing members for much lower nominal returns in a low interest rate and inflation environment." [2]

Blue-chip global management consultancy McKinsey published a study titled: *Look out below: Why returns are headed lower, and what to do about it.*[3]

Investors could be forgiven for being a little bewildered by such commentary when recent returns have been so strong.

So, what's going on?

Official interest rates anchor all asset class returns

In short, the tailwind to asset classes from falling global interest rates is largely behind us.

With interest rates and cash returns already at historic lows, the return potential for other asset classes is also lower. This stems from the fact that official interest rates (also known as the 'risk free rate') anchor returns for all other asset classes.

Investments outside of cash provide a 'risk premium' for investors to compensate for the risk they take on. The higher the risk of the investment, the higher the return above cash that the investor demands as compensation.

For example, there is the equity risk premium for investing in shares; and inflation and term premium (the risk of locking your money away for a long time) are the risk premia for government bonds.

As risk-free rates drifted lower over the past decade (in fact recent decades), valuations increased broadly across all asset classes.

Another way of unpacking the issue is to think of official interest rates as the 'denominator' when valuing assets.

For those that like the detail — assets are valued as a series of future cash flows (like dividends) which are converted into current day values by applying a discount rate. They're usually discounted by the cost of borrowing money, ie interest rates. Falling interest rates therefore mean the denominator is lower, leading to higher valuations of assets.

Falling interest rates are positive for returns from asset classes. However, persistently low interest rates are not so beneficial.

---

[1] *More super funds set to cut investment return targets as secular headwinds pick up*. Frontier Advisors, June 27, 2019. https://frontieradvisors.com.au/thinking/super-funds-cut-returns/ Accessed 11 September 2019.

[2] *Brace for 5pc super fund returns*. Joanna Mather, The Australian Financial Review, September 6, 2019. https://www.afr.com/wealth/superannuation/brace-for-5pc-super-funds-need-to-ready-members-for-lower-returns-20190906-p52om0 Accessed 11 September 2019.

[3] *Look out below: Why returns are headed lower, and what to do about it.* McKinsey article. Duncan Kauffman, Tim Koller, Mekala Krishnan, and Susan Lund. November 2016. https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/look-out-below-why-returns-are-headed-lower-and-what-to-do-about-it. Accessed 11 September 2019.

Assuming no other changes, a lower cash return means that looking forward, the return potential for riskier investments is lower as well.

This helps to explain why growing numbers of commentators are voicing their views on preparing investors for lower returns ahead.

Realistic investment objectives can assist planning

We agree that it's important to be up-front with investors and that's why we are adjusting down return objectives for the three MLC Wholesale Inflation Plus portfolios — MLC Wholesale Inflation Plus Conservative, MLC Wholesale Inflation Plus Moderate, and MLC Wholesale Inflation Plus Assertive.

We're also lowering management costs so the portfolios remain competitive, and expressing investment objectives on an "after management costs" rather than "before fees" basis for the three MLC Inflation Plus portfolios.

Doing so will help investors set more realistic expectations for their portfolios, and make it easier to track performance against inflation. After all, investors receive after-fees returns and the change means that MLC Inflation Plus portfolios' investment objectives and returns will reflect investors' experience.

On the other hand, ignoring the risks prevalent in markets to try to achieve higher returns for such investments would be irresponsible. We don't believe our clients want that and we're not changing the way we've always managed the portfolios and will continue to manage them.

Rather, by being straight-forward on what is responsibly possible, we think investors and their financial advisers can work together to consider how a low return environment can be navigated to achieve investors' long-term return goals.

That said, it's important not to get anchored in the current investment environment; markets can change rapidly.

Although it may seem a big ask given the foreseeable investment environment, it may be the case that global interest rates will eventually drift back towards their long-term averages. If that eventuates, the investment industry would likely respond.

But for now, the responsible thing to do is to inform investors that historically low global interest rates mean that future investment returns are likely to be lower than what has transpired over the last decade.