IMPLICATIONS OF A LOW-RETURN MARKET ON STRATEGIC ASSET ALLOCATION

As moderate stock market returns and lower returns from bonds are expected over the next ten years, investors need to enhance their asset allocation with new asset classes and products to achieve a balanced return/risk profile

By Christian Kempe and Thomas Kurze

The decline of international stock markets between March 2000 and March 2003 has paralysed investors. During these three years stocks were "high risk with a relatively low return" whereas bonds were "low risk with relatively high return", thus challenging the well-known ingrained trade-off between risk and expected return. So what is the expected return from stocks in the next decade and what are the implications for strategic asset allocation?

Only by understanding where we have come from can we know where we are heading

From August 1982 to December 1999, one of the longest bull markets in history, the compounded real total return of the Dow Jones Industrial Average (DJIA) was 15% per year. Starting from high inflation levels at the beginning of the 1980s the adjustment to lower inflation rates resulted in a sharp fall in interest rates. This led to both falling bond yields and falling earnings yields, reflected in the rise in price/earnings multiples. As a consequence, the bulk of the realised return was attributable to unexpected windfalls from rising equity valuation multiples. During the 1990s investors enjoyed the best DJIA stock percent return by decade, as shown in Figure 1.

A range of significant developments fuelled the bull market of the past two decades. While the financial media expanded with more publications and greater coverage, the public discovered stocks as a means of retirement provision. The securities industry expanded almost exponentially, with mutual funds flourishing and an ever growing number of financial instruments. Additionally, there was a technology revolution surrounding the internet, which was comparable with the nineteenth century industrial revolution. A further decisive factor was the greatest increase in wealth and availability of credit in history. On top of that, the ascendancy of free market economics as represented by more free trade, deregulation, privatisation and tax cuts was positive for private entrepreneurs and hence equities.

Another important development was the collapse of Communism in the late 1980s. This led to a period of global political stability with a solid, non-inflationary economic environment. This resulted in reduced spending on defence and freed capital resources for use by the private sector. Some authors also emphasise the

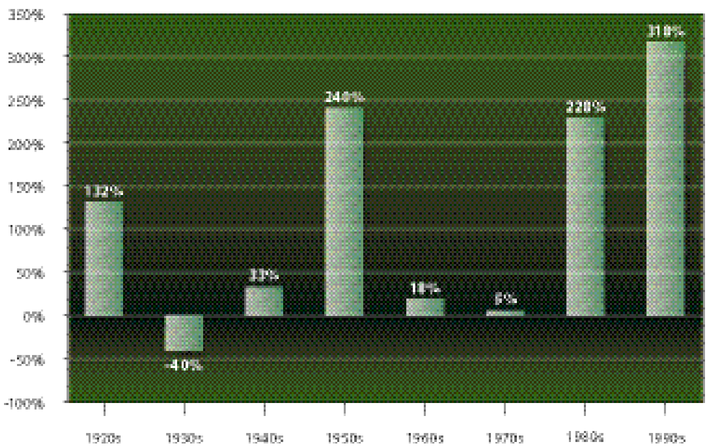

Figure 1: Dow Jones Industrial Average stock market performance by decade.

demographic effects of the baby boom of the 1960s. This generation reached the wealth-building years of its life in the 1990s, and, as a consequence, increased the demand for stocks. A study by The Bank Credit Analyst depicts three driving forces behind stock performance:

- corporate earnings;
- price/earning multiples (P/E);
- dividend reinvestments.

From 1950 to 1995, the total US stock market return average of 13.1% annually was composed of 7.3% corporate earnings growth, 1.5% in P/E improvement, and 4.3% in reinvested dividends. During the latter stage of the bull market, from 1996 to 1999, the stock market return averaged an astonishing 27.5%. That number was made up of 7.3% earnings growth, 18.1% in P/E improvement, and 2.1% in reinvested dividends (Table 1).

Expected return for US stock market

To gauge the expected stock return of the stock market in the coming years, the prevailing determinants of stock market returns mentioned above are a guide.

The Standard and Poor's 500's current trailing P/E is about 20. The P/E increase of the past two decades can be attributed to the decline in inflation seen since the early 1980s, which led to a rise in share prices that was much faster than growth in underlying corporate earnings. This one-off inflation adjustment has now run its course, with US inflation at around 2%. The current historical average P/E level stated above is only sustainable if inflation stays at an optimal level for equities, which should be around 2 to 4%.

The S&P 500's current dividend yield stands at approximately 1.7% – much lower than historical averages and well below the market's dividend yield of 6.7% in 1982. The propensity to higher retention rates partly reflects a shift towards more tax-efficient share repurchases. By the late 1990s, US firms disbursed cash flow more in share repurchases than in dividends. Furthermore, until May 2003, corporate dividends were taxed at a higher rate than long-term capital gains, making it more tax-efficient to retain earnings. However, a new US tax law lowered the top marginal tax rate on qualifying corporate dividends to 15%, generally the same as the rate for long-term capital gains. Consequently, the after-tax advantage from capital gains as compared with dividends does not exist anymore. Dividend payout has already increased in the US: net individual dividend income rose by 50% in 2003 from $32.7 billion to $49.1 billion.

Current low yields for bonds and stocks are therefore in stark contrast to the situation in the early 1980s. From the vantage point of the present abnormally low yield level, the prospects for rising valuation levels are limited. Furthermore, payout ratios equivalent to historical averages will probably not be reached in the short term. Lower dividend yields will result in lower total equity return.

What about corporate earnings growth and the extent to which shareholders participate in the growth of the economy? Part of economic growth is the creation of new enterprises., but the investor who owns today's enterprises does not own tomorrow's new enterprises. Empirical evidence indicates that earnings growth lags GDP growth by about 2% per annum. In the past century (1900–2001) US GDP growth averaged 3.3% in real terms, compared with 1.5% earnings growth. At the moment, US profits are high in relation to US GDP, so it seems unrealistic to assume that over the next ten years stock price appreciation can exceed GDP growth.

	1950–1995	1996–1999
Corporate earnings growth (%)	7.3	7.3
+ P/E improvement (%)	1.5	18.1
+ Reinvested dividends (%)	4.3	2.1
Total stock market return (%)	13.1	27.5

Table 1: Breakdown of US stock market return.

US stock market rate of return for the next ten years

For the US stock market the rate of return for the next ten years should be 8 to 9% – well below the long-term average. This estimate results from a combination of the current low dividend yield and the expected corporate earnings growth rate, both related to expected price appreciation rates. Some years will exhibit higher returns and some will even exhibit negative returns as part of the normal ebb and flow of financial markets. In addition to our subdued view on future returns, we are also convinced that the heightened terrorist threat will add to investor uncertainty and cause higher market volatility.

Implications for strategic asset allocation

In accordance with a wide range of academic studies, up to 90% of a portfolio's returns are determined by asset allocation. One of the consequences of this is, that portfolio management should concentrate on seeking asset classes with favourable risk/return profiles with low, preferably negative, correlations to each other. In the past, most investors have traditionally allocated their overall assets to the three asset classes of equities, bonds and cash. Because of the expectation of a more subdued equity market, investors should now be looking for ways to ensure that their portfolios are roadworthy for the changed environment.

In a low-return world, any extra percentage point counts. In this environment the relevance of dividends as a component of a stock's total return increases and can become critical in providing an acceptable return. Investors should maintain a bias towards stocks with favourable dividend yields. Recent empirical research indicates that companies with higher payout ratios have significantly higher long-term earnings growth than companies with lower payout ratios.

Investors should allocate more funds to economies with a higher growth potential. As Asia is expected to expand much faster than the US and Europe in the coming years, it is worth considering increasing the weight of Asian stocks in the strategic asset allocation.

Commodities (e.g. gold, energy, precious metals) should be also considered. In most cases, they offer a natural hedge against central banks pursuing inflationary policies. Given the low correlation to the equity market, commodities provide an opportunity to diversify a portfolio.

As we are convinced that we are likely to see a more nondirectional, unstable equity market in the next decade, the inclusion of hedge funds in strategic asset allocation may be appropriate. Hedge funds pursue a strategy of maximising absolute return by avoiding any benchmark fixation. They use a broad range of instruments such as derivatives, leverage, short selling, or arbitrage on different markets. In most cases their returns are largely independent of the stock market.

With respect to the challenges of the expected low-return market it would also be expedient to include new financial products in strategic asset allocation. We suggest the inclusion of a variety of structured products, which are gaining importance globally. One example is discount certificates. The certificate owner has limited upside potential compared with the direct investment in stocks, but is able to achieve double-digit returns in sideways markets.

Summary

Financial planners and individual investors should not use historical returns of the past two decades as a proxy for expected returns for the next decade. The lofty returns of the 1980s and 1990s should be considered an aberration and stemmed largely from rising valuation levels and high dividend yields, which have since diminished. We expect moderate stock market returns for the next ten years. Low government bond yields also suggest lower returns from bonds than during the past couple of decades. Investors need to enhance their asset allocation by looking at new asset classes and products to achieve a balanced return/risk profile on the basis of their personal financial goals and risk limitations.◆

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