Investment outlook

What to expect in the wake of diminishing bond yields

MJW Topix

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The implications of lower interest rates

The trend over recent years has been a continual lowering of interest rates. This was exacerbated by the quantitative easing programmes that followed the global financial crisis in 2008. More recently, central bank responses to the 2020 economic shutdowns have left interest rates very low. The yield on 10 year Government bonds is currently around 0.9% both in the USA and domestically.

In some sense this has been good news for bondholders, who enjoyed mark-to-market capital gains on the ride down. Ultimately however, this trend has soured the outlook for fixed interest returns in the future. Low prevailing interest rates mean that, in the absence of further capital gains, returns will be low.

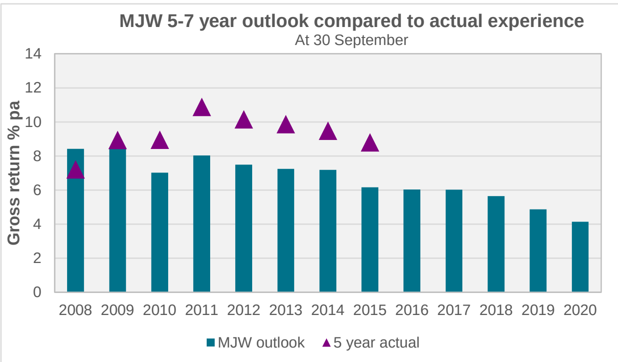
This has flowed into the return outlook for equities and other asset classes too. (The alternative is to assume a large increase in risk premia.)

The approach we take for our capital markets modelling is to neutrally forecast returns for the next five to seven years based on prevailing market conditions. Consequently, most of our clients have had to come to terms with an increasingly worsening outlook for their investments.

Holding ourselves to account

While our model is used to predict the future, it is educational to take a glance in the rear-view mirror from time to time. To do this, we have looked at a hypothetical balanced fund with 60% invested in growth assets.

The following chart shows bars with our return expectations as at 30 September of each year. Overlayed are points showing the subsequent five-year return. For example, the rightmost triangle shows the balanced fund return from 30 September 2015 was 8.8% pa compared with our more modest outlook of 6.2% pa at the time.



(All figures in this newsletter are before tax, fees and active management.)

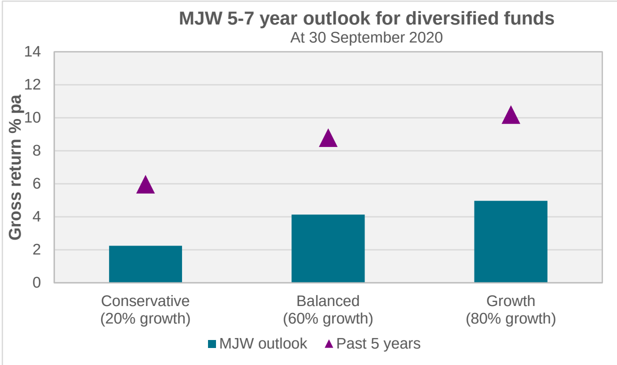
Markets have generally overshot our expectations. This illustrates how “surprisingly” strong they have been in the wake of continued central bank support.

It is perhaps fair criticism to say that our investment modelling has been conservative. We did not predict the strength of capital appreciation in either equity or bond markets. However, we are pleased with the review of these results. Our clients have not been in a position of over-promising and under-delivering to their stakeholders.

Looking forward

The other startling feature is the considerable reduction in our outlook. For this balanced fund, the expected five to seven year return has dropped from 8.4% pa in 2008 to 4.1% pa today.

The following chart shows our current expectations for funds with different levels of growth assets and contrasts this with the results that have been realised to date.



The gap between what investors have received over the last five years and what we expect for the next five years is stark: the difference for a balanced fund investor is 4.7 percentage points per annum.

This creates challenges for investors who need to meet their financial goals. While we may be proved wrong and future returns turn out not to be as weak as we fear, it seems unlikely that returns will be nearly as strong as what has been received recently. We think it is unlikely that even an aggressive portfolio will hit double-digits in the next five years.

Thus, investors are forced to either lower their expectations or seek greater returns. This could include:

- Moving the portfolio into more risky asset classes and away from bonds and cash.
- Employing active managers seeking to outperform the market.
- Concentrating on reducing fees and costs, and optimising implementation.
- Accessing alternative risk premia such as illiquidity, inflation, or sub-investment grade credit.

However, none of these tactics provides a guarantee of better returns. At the very least, investors need to communicate the potential for lower returns in the future to their stakeholders. Investors have difficult decisions ahead.

ABOUT MELVILLE JESSUP WEAVER

Melville Jessup Weaver is a New Zealand firm of consulting actuaries providing advice on investment consulting, superannuation, and insurance. The firm, established in 1992, has offices in Auckland and Wellington and is an alliance partner of Willis Towers Watson.

For further information please contact:

Ben Trollip 09 300 7315 — *Ben.Trollip@mjw.co.nz*

William Nelson 09 300 7150 — *William.Nelson@mjw.co.nz*