AMP CAPITAL

Investment returns over next five years are likely to slow

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Key points

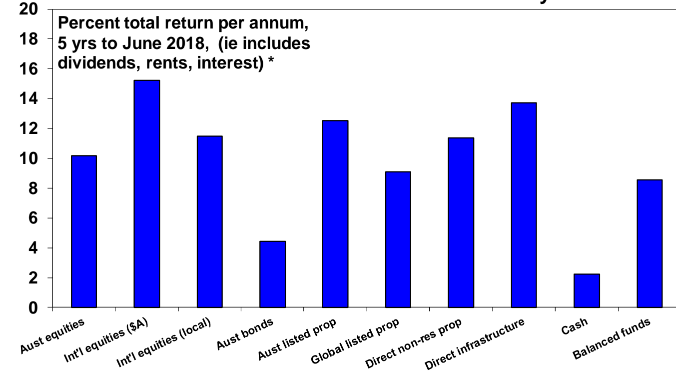
> The continuing slide in investment yields across most major asset classes points to a constrained medium-term return outlook. For a diversified mix of assets, this has now fallen to around 6.2% on our projections.

> The key for investors is to have realistic return expectations; allow that inflation is also low so real returns aren't down as much; and focus on assets with decent and sustainable income.

Introduction

The past five years have seen pretty good returns for well-diversified investors. While cash and bond returns have been modest, growth assets have been strong. Average balance growth superannuation funds have returned 8.5% pa over the five years to June and that's *after* fees and taxes. This is particularly impressive given that inflation has been around 2%.

Solid investment returns over the last five years



Source: Thomson Reuters, Bloomberg, Morningstar, AMP Capital

Shares have climbed a wall of worry in recent years with a revolving door list of worries around Europe, deflation, inflation, rate hikes, Trump, North Korea, China, trade, house prices, etc. And unlisted commercial property and infrastructure have benefitted from an ongoing search for yield. But can it continue over the next five years? This note looks at the main issues.

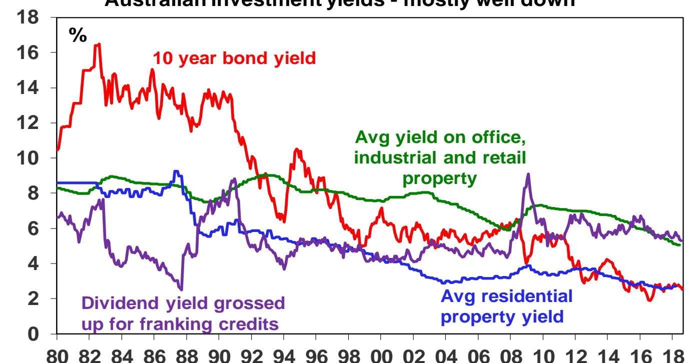
Declining medium-term return potential

While investment returns have been good, the medium-term (say 5-10 year) potential from major asset classes has been moving down. Investment returns have two components: yield (or income flow) and capital growth. Looking at both of these components points to lower average investment returns over the next five years compared to the last five years.

First, it's well known that investment yields are not what they used to be. Back in the early 1980s the medium-term return potential from investing was pretty solid for the simple reason that interest rates, bond yields, dividend yields and rental yields were so high. The RBA's "cash rate" was around 14%, 3-year bank term deposit rates were around 12%, 10-year bond yields were around 13.5%, property yields were running around 8-9% and dividend yields on shares were around 6.5% in Australia and 5% globally. Such yields meant that investments were already providing very high income and only modest capital growth was necessary for growth assets to generate good returns. As it turns out, most assets had spectacular returns in the 1980s and 1990s and balanced growth superannuation fund returns averaged 14.1% in nominal terms and 9.4% in real terms between 1982 and 1999 (after taxes and fees).

Since the early 1980s, investment yields have mostly fallen and this has continued over the last five years. See the next chart.

Australian investment yields - mostly well down



Source: Bloomberg, REIA, JLL, AMP Capital

Today the cash rate is 1.5%, 3-year bank term deposit rates are 2.5%, 10-year bond yields are 2.5%, gross residential property yields are around 3%, commercial property yields are just above 5%, dividend yields are still around 5.3% for Australian shares (with franking credits) but they are around 2.4% for global shares. This on its own points to a lower return potential.

Second, the capital growth potential from growth assets is likely to be constrained relatively to the past reflecting more constrained nominal economic growth. Several megatrends are likely to impact growth over the medium term. These include:

- Continued slower growth in household debt.
- An ongoing backlash against the economic rationalist policies of globalisation, deregulation and small government, thanks in large part to weak wages growth and rising inequality resulting in populist, less market friendly policies – such as trade protectionism and rising regulation.
- Rising geopolitical tensions – most notably as the US attempts to constrain the rising power of China.
- Aging and slowing populations – resulting in slowing labour force growth and rising pressure on public sector budgets.

- Constrained commodity prices – as the surge in resource investment last decade boosts supply.
- Technological innovation and automation.
- Continuing rapid growth in Asia and China's middle class.
- Rising environmental awareness and pressure to slow the human contribution to global warming.
- The energy revolution resulting in a shift to sustainable energy as its relative cost continues to collapse.

Most of these will constrain economic growth & hence investment returns, with declining population growth the most significant.

Medium-term return projections

Our approach to get a handle on medium-term return potential is to start with current yields for each asset class and apply simple and consistent assumptions regarding capital growth reflecting the above-mentioned megatrends. We also prefer to avoid forecasting and like to keep the analysis simple.

- For bonds, the best predictor of future medium-term returns is current bond yields. If a 5-year bond is held for five years its initial yield will be its return. We use 5-year bond yields.
- For equities, a model of current dividend yields plus trend nominal GDP growth (a proxy for capital growth) does a good job of predicting medium-term returns. This approach avoids getting too complicated.[1]
- For property, we use current rental yields and likely trend inflation as a proxy for rental and capital growth.
- For unlisted infrastructure, we use current average yields and capital growth just ahead of inflation.
- In the case of cash, the current yield is of no value in assessing its medium-term return. So we assume a medium term average that allows for higher than normal bank rates relative to the cash rate and high household debt.

Our latest return projections are shown in the next table.

Projected medium term returns, %pa, pre-fees and taxes

	Current Yield #	+ Growth	= Return
World equities	3.0^	4.1	7.1
Asia ex Japan equities	2.1^	7.0	9.1
Emerging equities	1.5^	7.0	8.5
Australian equities	4.1 (5.3*)	3.5	7.6 (8.8*)
Unlisted commercial property	5.1	2.0	7.1
Australian REITS	4.4	2.3	6.7
Global REITS	4.1^	2.0	6.1
Unlisted infrastructure	4.9*^	3.2	8.1
Australian government bonds	2.3	0.0	2.3
Australian corporate debt	3.3	0.0	3.3
Australian cash	2.7	0.0	2.7
Diversified Growth mix *			6.2

Current dividend yield for shares, distribution/net rental yields for property and duration matched bond yield for bonds. ^ Includes forward points. * With franking credits added in. Source: AMP Capital.

The second column shows each asset's current income yield, the third shows their 5-10 year growth potential, and the final column their total return potential. Note that:

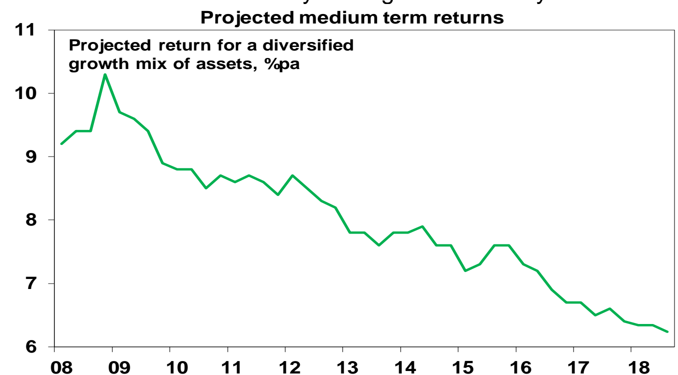
- We assume inflation averages around or just below central bank targets.
- For Australia we have adopted a relatively conservative growth assumption reflecting constrained commodity prices and slower productivity growth.
- We allow for forward points in the return projections for global assets based around current market pricing – which adds 0.6% to the return from world equities.

Combining the returns indicates the implied return for a diversified growth mix of assets has fallen to 6.2% pa.

Key observations

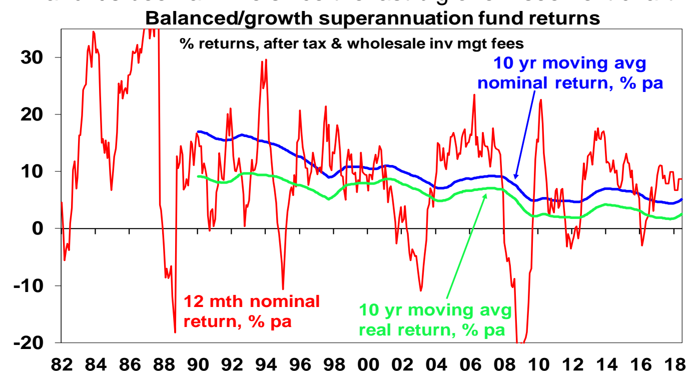
Several things are worth noting from these projections.

- The medium-term return potential using this approach has continued to fall due largely to the rally in most assets which has pushed investment yields lower. Projected returns using this approach for a diversified growth mix of assets has fallen from 10.3% pa at the low point of the GFC in March 2009 to 6.2% now. Five years ago it was nearly 8%.



Source: AMP Capital

- Government bonds offer low returns due to ultra-low yields.
- Unlisted commercial property and infrastructure continue to come out relatively well, reflecting their higher yields.
- Australian shares stack up well on the basis of yield, but it's still hard to beat Asian/emerging shares for growth potential.
- The downside risks to our medium-term return projections are that: the world is plunged into another recession driving another major bear market in shares or that investment yields are pushed up to more normal levels as inflation rebounds causing large capital losses. Just allow that drawdowns in returns tend to be infrequent but concentrated and it's been a while since the last big one – see next chart.



Source: Mercer Investment Consulting, Morningstar, AMP Capital

- The upside risks are (always) less obvious but could occur if we see improving global growth but inflation remaining low.

Implications for investors

- First, have reasonable return expectations. Low yields & constrained GDP growth indicate it's not reasonable to expect sustained double-digit returns. In fact, the decline in the rolling 10-year average of super fund returns indicates we have been in a lower-return world for many years – it's just that it only becomes clear every so often with bear markets with strong returns in between. See the last chart.
- Second, much of this reflects very low inflation - real returns haven't fallen as much.
- Finally, focus on assets with decent sustainable income flow as they provide confidence regarding future returns.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital

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[1] Adjustments can be made for: dividend payout ratios (but history shows retained earnings often don't lead to higher returns so the dividend yield is the best guide); the potential for PEs to move to some equilibrium level (but this relies on forecasting the equilibrium PE which can be difficult and in any case extreme dividend yields send strong valuation signals anyway); and adjusting the earnings/capital growth assumption for some assessment regarding profit margins (but again this is hard to get right). So we prefer to avoid forecasting these things.

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