portfolio construction forum

Challenging assumptions

Warryn Robertson | Lazard Asset Management | 18 August 2017

This paper argues that a major issue facing investors is that the returns that they will achieve across a balanced portfolio over the medium term are likely to be less than returns they have come to expect. This environment is going to force investors to challenge some long held assumptions.

The first assumption under challenge is that the past offers a reliable guide to the future, in terms of asset class returns and the macroeconomic outlook. Thirty years of synchronised and gradually declining global interest and inflation rates has ended and this will have profound implications for asset class returns.

The second assumption being challenged is that traditional relative risk/return approaches can still deliver the returns investors need. Investors will need a different approach to managing risk, focused on absolute, rather than relative risk and investors must get their valuation right, because in a low return world, small mistakes can add up to big losses.

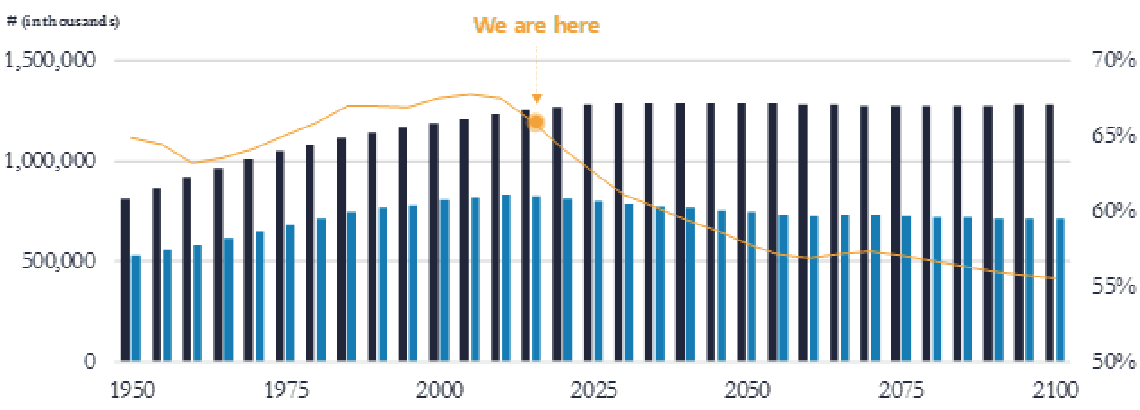
ASSUMPTION 1: THE NEXT 30 YEARS WILL LOOK LIKE THE LAST 30

The global economy – particularly developed economies – face several structural factors that combined are resulting in slow growth and low inflation. These structural factors are long-cycle changes.

Demography

One explanation for low growth is demographics. The ageing of the population is certainly a reaching a tipping point. According to UN data, the population in the developed world aged 15-64 (or the working age) as a percentage of total population is now starting to fall and projections are that it will continue to fall (Figure 1). If this is a source of the anaemic growth, then we should expect growth across the G7 nations and eastern Asia to remain low.

Figure 1: Demographic tipping point

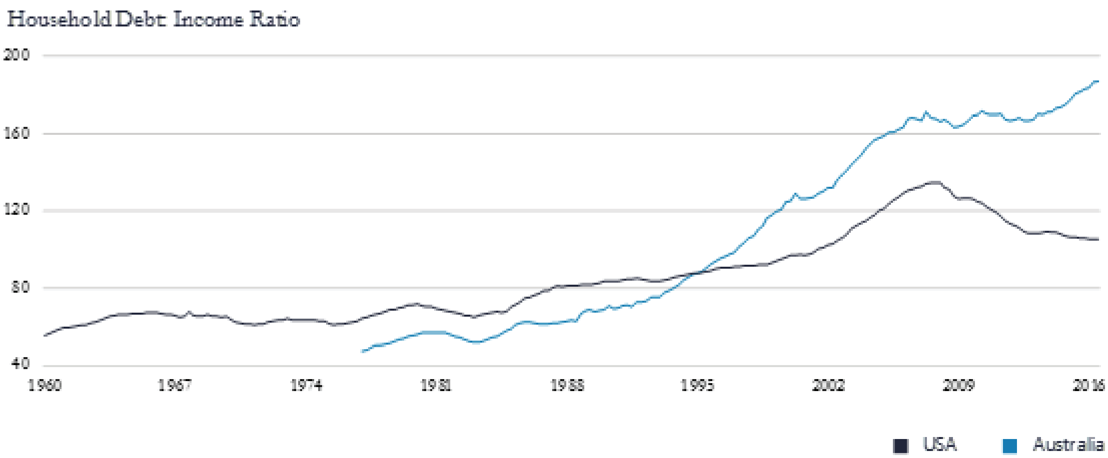


Source: United Nations, Lazard

Debt levels

The overhang of the global financial crisis and extreme private and public debt levels in much of the Western world is another explanation for low inflation. Given Australia's historically high debt load, this is perhaps the most concerning reason from an Australian investor's perspective. Australia has more acute household debt levels than most parts of the world. Not only was the Australian credit binge pre-crisis larger than that in the United States, but since the crisis Australian households have continued to borrow (Figure 2).

Figure 2: A balance sheet (febt) driven recession
As at 30 September 2016

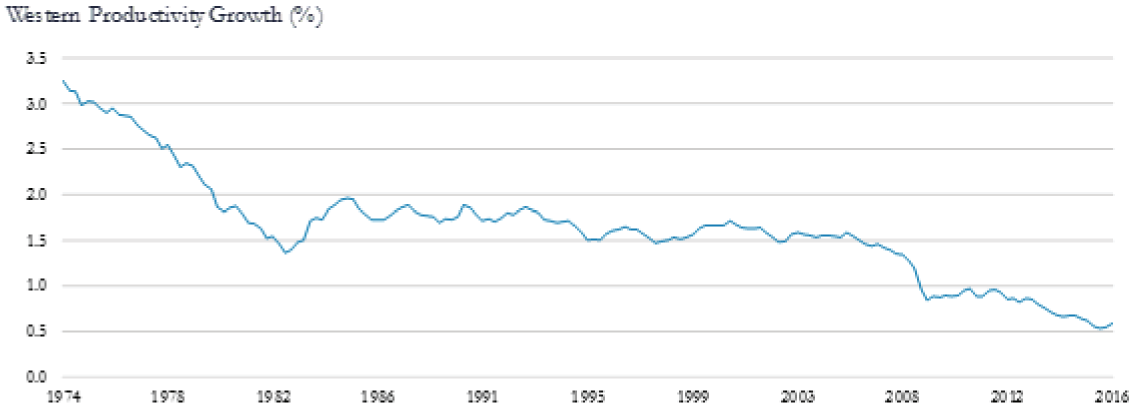


Source: Merrill Lynch, Minack Advisors

Productivity Growth

Other economists argue that secular stagnation is driven by the decline in productivity growth, which has slid in the eight major economies (Figure 3).

Figure 3: Declining productivity growth
As at 31 March 2016

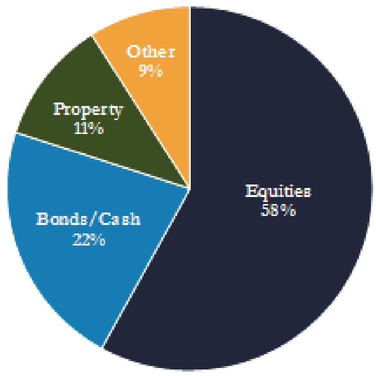


Source: Minack Advisors. Note: Data does not adjust for hours worked, but this should be a slowly varying factor only. 10 Year Change in GDP/Employment Ratio: Australia, Canada, France, Japan, United Kingdom, United States.

ASSUMPTION 2: TRADITIONAL RELATIVE RISK/RETURN APPROACHES ARE THE FUTURE

This macroeconomic picture is a major challenge for the traditional balanced approach to portfolio construction. The perceived wisdom is that the "standard" 60/40 portfolio with a mixture of equities, direct investments, bonds and cash (Figure 4) has served investors well.

Figure 4: The Traditional Balanced Fund



Source: Chant West AA Survey

To some extent, this is true. However, the last year 30 years has seen a long-cycle bull run in both equities and fixed income markets. Arguably, almost any diversified asset allocation mix between equities and bonds could have generated an adequate return over this period (Figure 5).

Figure 5: A 30-year bull-run

	% Allocation	30-ur Return (%pa)
Australian Shares	30%	10.5%
International Shares	20%	8.4%
Listed Prop & Infrastructure	5%	10.9%
Direct Prop & Infrastructure	5%	11.2%
Australian Bonds	15%	9.0%
International Bonds	10%	9.8%
Inflation Linked Bonds	5%	8.4%
Cash	10%	7.0%
Balanced Fund Return		9.4%

Source: Lazard, Vanguard, Chant West AA Survey

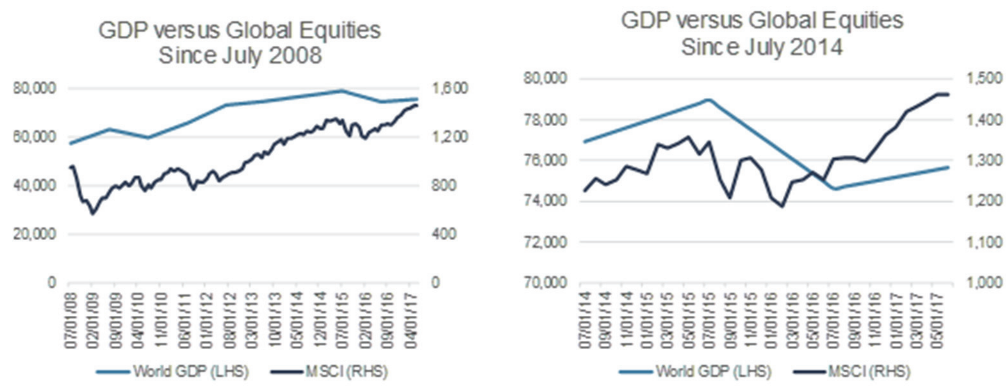
Achieving these returns from the broad market over the next 30 years seems highly unlikely. Global equity and Australian equity (albeit to a lesser extent) markets are currently overvalued, in the author's view. Fixed income markets look equally stretched, while the author would argue that direct property and infrastructure are trading at the most extreme valuation level. Merely investing in the beta of these asset classes seems likely to yield a return that is much lower than the expected return of between 8% to 10% per annum.

Global Equities

There is significant risk in global equity market benchmarks. Investors who passively hold broad indices necessarily own many overvalued stocks, in the author's view. In addition, many active strategies are also closet benchmark strategies that carry similar risks.

Global equity markets appear divorced from the underlying macroeconomic environment. Global growth has stagnated but valuations have risen, particularly since 2014 (Figure 6).

Figure 6: Valuations have separated from fundamentals



Source: Worldbank, MSCI

Why is this such a problem? Firstly, it is worth remembering that any company valuation has simply two parts:

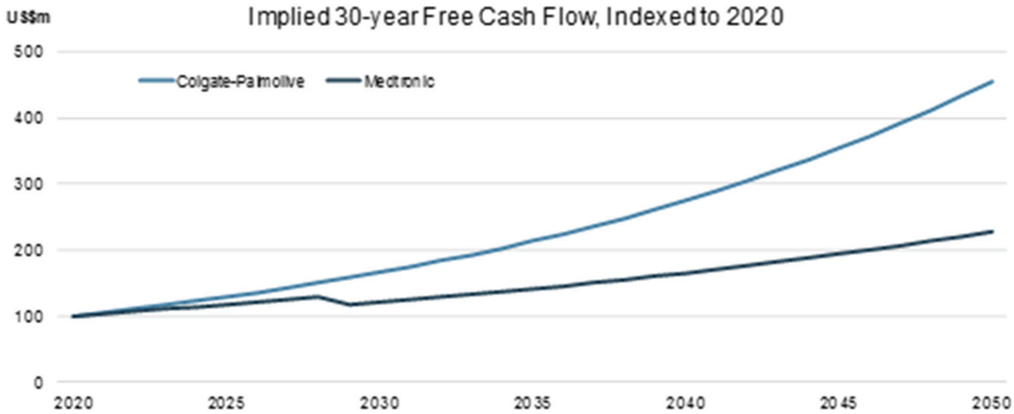
- earnings or cash-flow; and,
- multiple/rating or discount rate.

This is basis for the Golden Rule of equity investing - that in the long-run, nominal interest rates must equal nominal GDP. This is important because what it essentially does is link the numerator (cash flow or earnings growth) with the denominator (the discount rate). As a result, there's no need to pick a short-run macroeconomic outcome in valuation forecasts.

For example, if long-term nominal GDP in the US is forecast at 4.50% but it is actually 3.50%, then cash flow and earnings will be lower. Offsetting this will be the use of a lower risk free rate which in turn produces a lower discount rate. If GDP is higher than expected, cash flows will be higher but so too should interest rates and, therefore, a higher discount rate. In this way, valuations are far more robust and consistent. In times of heady investment markets, like today, investors often break this golden rule and build heroic growth assumptions into the future without applying higher interest rates. This drives excessive valuations in global equity markets, with many investors applying higher economic growth rates, but maintaining low rates into perpetuity.

This can have a big impact on individual stock valuations. For some defensive stocks, particularly in the consumer staples space, arguably heroic growth assumptions are implied in the current share price. The classic example today is Colgate Palmolive. Figure 7 compares the implied 30-year free cash flow of Colgate versus Medtronic. Medtronic is a health care stock and the world's leading provider of pacemakers, with an strong economic moat. It appears that Colgate's growth rates are excessively optimistic and over time this adds up to a valuation that appears extremely over-valued.

Figure 7: Small inconsistencies can have a big impact on valuation risk
Data as of 24 March 2017



Source: Factset, Lazard

Risk is the probability of permanent capital loss

In the author's view, risk should be defined as the probability of a permanent loss of capital. Many investors focus on other definitions of risk which they see as being more relevant such as volatility, or being different from a benchmark or index.

However, by thinking about risk in absolute terms (that is, the risk of losing capital), investors should not confuse being very different to the index as necessarily being high risk. The real risk may in fact lie in the many overpriced securities in those benchmarks. Choosing to hold a concentrated portfolio of only the more attractively priced securities may actually be the lower risk option.

In equities, during the last eight years just being in the market was enough. Beta returns were healthy enough that alpha became a secondary concern. But now asset allocators need to be prepared to be very differently.

In the author's view, the benchmark, or near to the benchmark, is not going to be the place to be over the coming years. In the current environment, diversification across a broad range of stocks through an index fund may underperform a more selective, value-focused portfolio.

A valuation focus will add up

Investors must consider the risk that the next 30 years may not look like the last 30 years. Economic realities may dictate that returns will be lower and more volatile. This return environment would challenge the standard 60-40 balanced fund that has long been considered the most efficient portfolio allocation. For any global or international allocation, market cap benchmarks at current valuations represent significant risk and investors should consider thinking about risk in absolute rather than relative returns.

The question is – how can you manage the risks better so that you can maximise returns from your equity allocation?

Investing in global equities requires that you be concentrated and have a strong focus on valuation. Valuation is as important to risk, as it is to returns and small inconsistencies can have a big impact on valuation risk. Those who do not adapt their global equity portfolio to a framework focused on valuation will likely suffer disappointing investment returns.

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