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Special Topic

Ensuring positive returns in a low growth world

- Slow but positive global economic growth in the medium term
- Equity returns less growth dependent than generally perceived
- Fixed income a necessary diversifier of equity risks
- Multi-asset investment portfolios: attractive returns at acceptable levels of risks – also in the future.

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World economy: The medium term

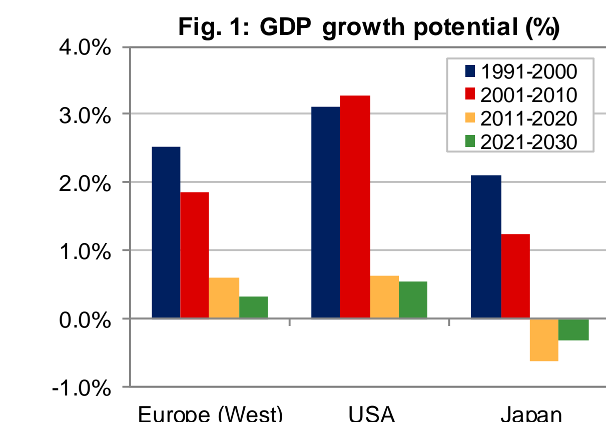
Positive economic trends, despite modest growth

In this topical study, we take a look at how asset management fits into a slow-growth world.

Although economic and earnings growth may well remain lower than in the past, our analysis suggests that growth is less important a driver of equity returns than generally perceived.

The return perspectives for multi-asset portfolios remain positive in the medium term. In addition, we argue that the key principles of asset management, most notably diversification, are as relevant as ever in providing adequate returns at commensurate levels of risk.

Fig. 1: GDP growth potential (%)



Source: Census Bureau, Conf. Board, own calc.

Demographics and productivity

The principal factors constraining economic expansion are weak demographics and low productivity growth. Table 1 shows a shrinking working-age population and a marked deterioration in productivity growth the current decade.

The reasons for lackluster productivity growth are manifold. First and foremost, there is currently no large-scale driver such as the mass adoption of the Internet and mobile communications in the 1990s or the commodities boom in the 2000s. Other reasons include measurement errors (i.e. technological progress is not accurately captured by standard measurement techniques) or the fact that anemic growth feeds on itself as it requires fewer productivity-enhancing capacity additions.

Lackluster productivity growth is a global phenomenon, with only a few countries bucking the trend. Among them are India and Spain, where reforms seem to have been successful at boosting labor productivity. Barring progress in economic reform or the emergence of a breakthrough technology (in energy or robotics, for example), our central case remains that productivity gains will stay

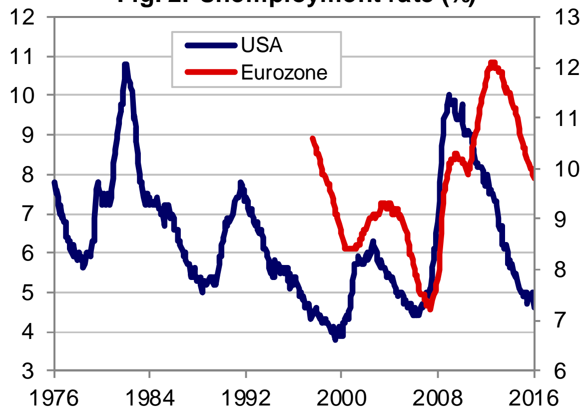
Table 1: Productivity, labor markets and economic growth potential (change, % p.a.)

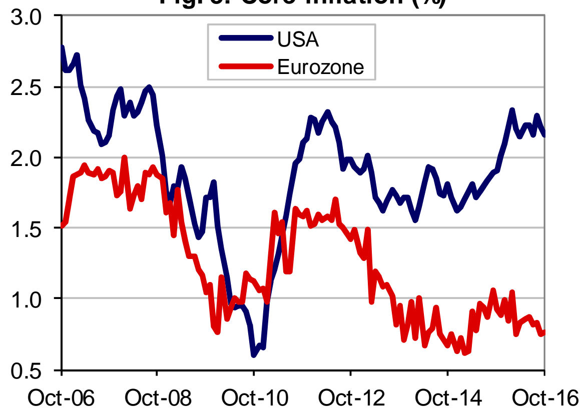
	Labor productivity				Working age population				GDP growth potential			
	1991-2000	2001-2010	2011-2020	2021-2030	1991-2000	2001-2010	2011-2020	2021-2030	1991-2000	2001-2010	2011-2020	2021-2030
Western Europe	**2.2**	**1.5**	**0.6**	**0.6**	**0.3**	**0.4**	**0.0**	**-0.3**	**2.5**	**1.9**	**0.6**	**0.3**
Germany	2.8	1.6	0.8	0.8	0.2	-0.4	-0.5	-1.1	3.0	1.3	0.3	-0.3
France	2.1	1.4	0.8	0.8	0.4	0.5	-0.1	-0.1	2.5	2.0	0.7	0.7
Italy	1.6	0.3	0.1	0.1	0.0	0.3	0.0	-0.4	1.6	0.7	0.1	-0.3
Spain	1.2	0.7	1.3	1.3	0.7	1.3	0.5	0.2	2.0	2.0	1.8	1.5
United Kingdom	2.5	1.9	0.5	0.5	0.3	0.7	0.2	0.1	2.9	2.6	0.6	0.6
Switzerland	0.9	1.6	0.3	0.3	0.4	0.7	0.5	0.1	1.4	2.4	0.8	0.4
Emerging Europe	**0.5**	**4.7**	**1.3**	**1.3**	**0.6**	**0.6**	**-0.1**	**-0.2**	**1.4**	**5.2**	**1.0**	**1.0**
United States	**1.8**	**2.2**	**0.3**	**0.3**	**1.3**	**1.1**	**0.3**	**0.2**	**3.1**	**3.3**	**0.6**	**0.5**
Latin America	**1.6**	**1.2**	**0.8**	**0.8**	**2.0**	**1.7**	**1.3**	**0.7**	**3.8**	**2.9**	**2.1**	**1.5**
Brazil	1.9	1.5	0.0	0.0	2.3	1.6	1.1	0.4	4.2	3.1	1.1	0.4
Japan	2.1	1.9	0.4	0.4	0.0	-0.6	-1.0	-0.7	2.1	1.2	-0.6	-0.3
Asia (excl. Japan)	**4.5**	**6.0**	**4.5**	**4.5**	**1.9**	**1.7**	**1.0**	**0.5**	**6.4**	**7.5**	**5.0**	**4.5**
China	6.1	8.8	5.1	5.1	1.3	1.3	0.0	-0.4	7.4	10.2	5.1	4.7
India	3.4	5.1	6.2	6.2	2.3	2.0	1.6	1.1	5.8	7.1	7.9	7.3
Indonesia	2.4	2.8	4.0	4.0	2.3	1.5	1.3	0.6	4.7	4.4	5.4	4.7
World	**2.2**	**2.4**	**1.7**	**1.7**	**1.7**	**1.6**	**1.0**	**0.7**	**3.1**	**3.3**	**2.0**	**1.7**

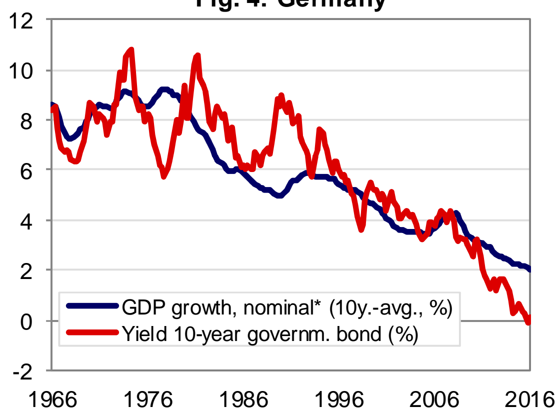
Data productivity/hours w orked exclude severe recession years 2008-2009, w ith forecasts starting 2011 based on data reported for the years starting 2011. Estimated economic grow th potential = sum of grow th w orking age population and productivity (regions/w orld: GDP-w eighted average). China data based on Conference Board estimates. Source: U.S. Census Bureau, Conference Board, World Bank, ow n calculations

World economy: The medium term

Business cycles, inflation and interest rates







comparatively low. While any improvements in global productivity trends would be welcome news for investors, the current situation will continue to weigh on investment returns, but less so than often feared.

Business cycles and inflation

Business cycles continue to evolve in established ways in a slow-growth world. This is well illustrated by the drop in unemployment rates (clearly so in the U.S., and less so in the eurozone, see Fig. 2). The same appears true for inflation (see Fig. 3). Modest upward pressure in the U.S. and persistently low inflation in the eurozone are consistent with markedly different unemployment rates in the two regions.

There is therefore little evidence that business cycles and hence financial market dynamics are much different in the current slow-growth world than in the past.

Interest rates depend on growth

Interest rates are clearly driven by growth and inflation. There is indeed good evidence that the general level of interest rates is linked to the growth potential of an economy.

Fig. 4 shows, that the 10-year German government bond yield correlates well with economic growth over longer periods of time. As nominal growth (real growth plus inflation) has remained positive, bond yields should also be positive in Germany and Switzerland (similar to the U.S. or the U.K.). Only the aggressive monetary policies of both ECB and SNB managed to push yields into negative territory.

Although the lagged effects of the eurozone debt crisis will keep monetary policy unusually accommodative for some time, we nevertheless expect bond yields to gradually normalize in the coming years. We also see little reason to expect a zero interest rate environment to persist as it has in Japan, which is the only country where potential GDP growth is structurally negative – a sharp contrast to Europe and the USA.

Equity markets

Returns still potentially attractive in a slow-growth world

Investors tend to associate equity returns with price gains driven by earnings growth. History portrays a somewhat different picture. In the U.K. (the only European market with a long data history), dividends were as important a source of equity returns as price gains (Fig. 5). This is all the more true that dividend yields have been fairly steady over the past 120 years.

Assessing future shareholder returns

The fundamental principles of how shareholder returns are produced are straightforward. The free cash flows a company produces (operating cash flows minus capital expenditures) belong to its owners (shareholders). Total returns over the medium term thus are equal to the current free cash flow yield plus its growth over time. This in turn is equal to price gains plus the dividend yield (which is lower in the USA, as companies return more cash to shareholders via buybacks).

Current free cash flow yields (see Table 2) plus 3% growth (a conservative estimate for nominal economic growth) add to approximately 7%.

This level of shareholder returns is an attractive medium-term outlook.

Market volatility vs. fundamental trends

Obviously, equity performance varies greatly from one year to another. This is because financial markets continuously change their perceptions of risks, despite fairly stable underlying fundamental trends. There is, however, no evidence that market volatility is higher now than in the past (see Fig. 6).

Recessions (and the subsequent recoveries) will create cyclical swings in equity returns. With the U.S. business cycle fairly advanced (see Fig. 2), a recession is likely occur in the next 2-3 years. The Trump government's intention to support growth by increasing government spending and cutting taxes could, however, prolong the cycle or lead to a shallow recession.

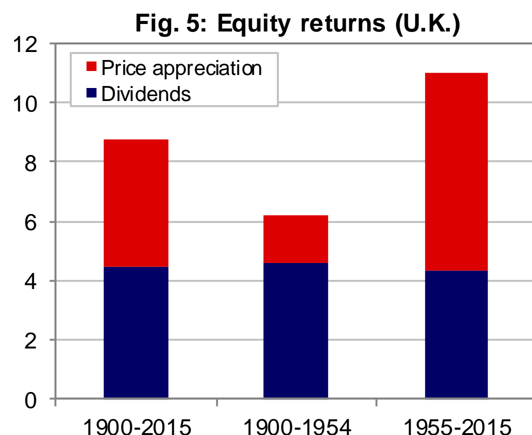
Despite a number of global economic and political risks, which will undoubtedly keep markets volatile, our analysis points to attractive equity returns on average over the medium term.

Table 2: Equity sectors

	Free CF yield*		Dividend yield*	
	Europe	USA	Europe	USA
Stable sectors	**4.4**	**3.6**	**3.7**	**2.5**
Consumer staples	4.7	4.8	2.9	2.7
Healthcare	4.7	6.1	3.2	1.8
Telecommunications	7.9	6.1	5.1	4.6
Energy	-1.3	-0.5	5.1	2.5
Utilities	5.4	-2.6	5.2	3.6
Financials	**-**	**-**	**4.4**	**1.6**
Cyclical sectors	**4.6**	**4.9**	**2.8**	**1.7**
Durable cons. goods	4.2	5.1	3.1	1.5
Industrial companies	4.8	4.0	2.8	2.1
Technology	3.0	5.5	1.9	1.5
Basic industries	4.7	3.5	2.5	2.1
Market	**4.4**	**4.6**	**3.5**	**2.0**

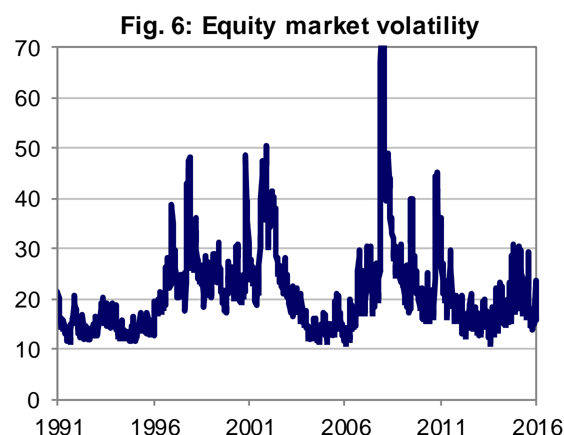
* As per 14-Dec-16, in %. CF=cash flows (Market FCF yield excludes financials). Source: Index provider

Fig. 5: Equity returns (U.K.)



Source: Barclays

Fig. 6: Equity market volatility



Source: Index provider

Asset Management

Risk optimization through diversified portfolios

Investing in marketable securities is about managing returns and risks with several asset classes.

Table 4 shows average returns and risks (volatility of returns) from the perspective of a Swiss-based investor. Domestic bonds carry the lowest risk, while equities provide better returns but require higher risk tolerance. The risks and returns of foreign currency bonds and gold are located between those two extremes.

The portfolio value of an asset class

While risk and return properties of single asset classes are well understood by most investors, less intuitively clear is an asset class's contribution in reducing overall portfolio risk.

The bottom row in Table 4 shows correlations with global equities (MSCI World). As equity markets around the globe almost always move in the same direction, their correlation coefficient is close to 1 (the value of the perfect correlation, when two investments always move in the same direction by the same amount).

Table 3: The benefits of diversification

	Aver. return	Best year	Worst year	Volatility
U.S. based investors				
Equities	11.5	38.0	-38.8	16.5
Bonds	6.9	40.4	-10.0	10.8
Average	9.2	39.2	-24.4	13.7
Balanced (50/50)	9.2	34.9	-10.5	9.9
Swiss based investors				
Equities	9.6	61.4	-34.8	22.1
Bonds	6.3	26.2	-5.3	7.1
Average	7.6	40.3	-17.1	13.1
Balanced (40/60)	7.6	35.6	-11.4	10.4

Note: Annual data 1955-2015, in %. "Balanced" is 50% equities USA, 40% equities in the Swiss portfolio (remainder=bonds).
Source: Ibbotson, Pictet, index provider, own calculations

Asset classes that exhibit negative correlation improve the diversification of a portfolio. In this view, domestic bonds stick out. Their correlation with equities is negative, and this property has been stable throughout history and – contrary to common wisdom – even over the past five years. The correlation is also fundamentally well anchored. A sharp economic downturn or even a recession most often results in lower equity prices but positive bond returns (driven by falling yields). Nevertheless, the correlation is not perfect (the coefficient is around -0.4 to -0.5). There are periods when returns of both equities and bonds are positive (e.g., when central banks lower interest rates) or negative (e.g., when inflation expectations rise).

The diversification effect is demonstrated in Table 3, which shows the annual returns and risks of equities, bonds and balanced portfolios (50%/50% equities and bonds in the U.S. and 40%/60% in Switzerland to get to similar portfolio volatility in both markets). The results are striking. Balanced portfolios have significantly better risk properties than the average of equities and bonds (volatility, worst year). In the U.S., the volatility of a balanced portfolio is even lower than that of a pure bond portfolio.

We thus believe that bonds, even at times of extremely low return expectations, continue to form an important part of a well-diversified investment portfolio. At the same time, it is of course necessary to manage technical parameters actively, dependent on the trend in yields and default rates.

Managing fixed-income investments

As we continue to use high-grade bonds to counterbalance equity risks in a diversified portfolio, in the current environment, their yields are extremely low and unattractive. We therefore look to enhance returns in the fixed-income allocation of a portfolio with alternative opportunities.

Bonds of emerging market borrowers issued in euros or U.S. dollars offer the potential to diversify, while

Table 4: Returns and risks (in Swiss francs)

	Equities				Hedge	Bonds			Currencies		Gold
	CH	Europe	USA	EMA	Funds	CHF	EUR	USD	EUR	USD	
Return p.a.	6.6%	5.0%	6.5%	4.6%	3.0%	3.1%	2.7%	3.9%	-1.9%	-1.3%	5.1%
Volatility	17.5%	21.2%	20.1%	28.4%	7.2%	2.8%	5.6%	9.8%	5.4%	9.9%	13.6%
Best quarter	17.3%	20.2%	14.4%	25.1%	4.5%	5.2%	7.3%	12.1%	5.2%	9.4%	15.7%
Worst quarter	-20.7%	-30.7%	-29.6%	-37.1%	-11.0%	-2.1%	-13.5%	-8.8%	-14.2%	-13.2%	-26.3%
Correlation	0.85	0.95	0.97	0.85	0.73	-0.42	0.04	0.18	0.33	0.45	0.14

Data: Latest 20 years. Correlation = with global equities. Source: Index provider, own calculations

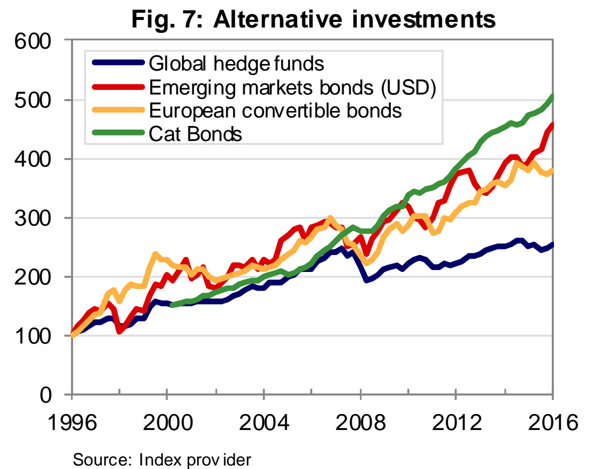
Asset Management

Return-enhancing asset classes

also providing attractive returns in their own right (see Fig. 7). Similar characteristics are offered by convertible bonds (bonds that can potentially be converted into equities and thus offer some upside). High yield bonds issued by companies with a lower credit rating offer attractive returns but with a significantly higher risk of default, and thus require a lot of diversification. Cat bonds generate returns by insuring natural risks. In the absence of very large insured catastrophes, risk-return properties have been attractive over the past twenty years. In addition, lending based products, such as Commodity Trade Finance (CTF) or Private debt provide attractive yields, but with specific risk characteristics.

Conversely, foreign currencies are largely a zero-sum game (Table 4), and bonds outside an investor's home currency tend to increase portfolio volatility without contributing much to returns.

Fig. 7: Alternative investments

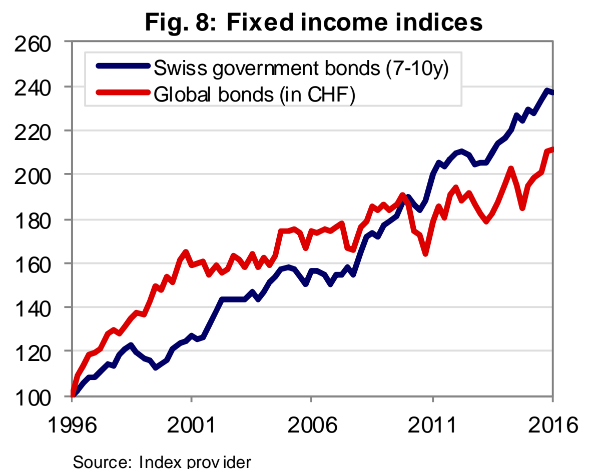


Source: Index provider

Hedge funds and gold: Diversification benefits, but low returns

Unlike equities and bonds, gold never pays interest or dividends and thus provides a performance only when its price moves higher. Since gold is largely uncorrelated with equities, it does offer some diversification benefits, even though capital gains have been lower in the long run (Fig. 9). Similarly, funds of hedge funds offer some diversification benefits, though returns arguably have fallen short of expectations in recent years. A good selection of strategies can, however, add value to the portfolio.

Fig. 8: Fixed income indices



Source: Index provider

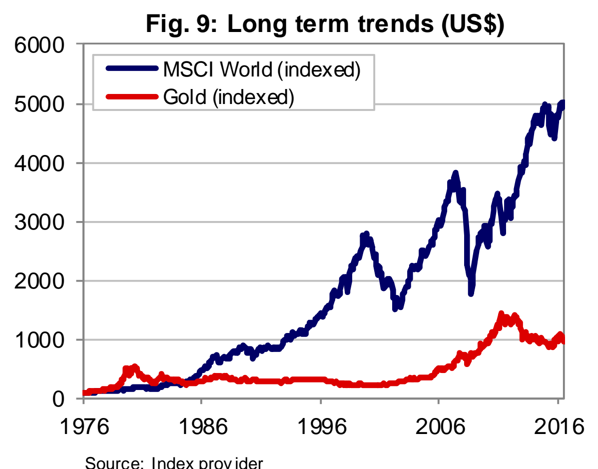
Conclusion: Equities as performance engine of a diversified portfolio

Even if economic growth remains lower than in the past, return prospects for investment portfolios remain attractive, thanks to the value creation potential of equities.

As long as the corporate sector keeps generating profits each year, free cash flows and dividends provide a good base for at least 5 to 7% equity returns over time.

Fixed income instruments play an important role in stabilizing a balanced portfolio's performance and provide some hedge for adverse economic conditions. In addition, return-enhancing strategies – adding a diverse set of investments such as high yield bonds, CTF, private lending, hedge funds and emerging markets – can add to performance if well diversified.

Fig. 9: Long term trends (US$)



Source: Index provider

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